Islamic Finance

A Development Opportunity for Egypt

Wafik Grais

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Foreword

by Magda Shahin, Director of Prince AlWaleed Center for American Studies and Research

Dr. Wafik Grais, a prominent economist and an international expert on Islamic Finance, graciously accepted to write the attached study on "Islamic Finance: A Development Opportunity for Egypt" to CASAR.

This high-level, specialized and well-searched paper gives an in-depth insight in Islamic finance, which is gaining prominence in many Islamic nations since the beginning of the current millennium. Egypt's official interest in this type of finance has started with its January 25th, 2010 eruption and the Moslem Brotherhood accessing power one year after. The paper offers a thorough and comprehensive overview of the recent history and current situation of Islamic finance as well as its core principles and modes of operations. Well supported by data and evidence, this paper is surely needed during the current period of Arab Spring and the rise of Islamic movements, as it will give the decision maker an overview of Islamic finance, its shortfalls, opportunities and the challenges it faces.

In addressing the opportunities Islamic finance offers, the paper provides an interesting perspective for adopting Islamic finance in Egypt and boost the country's development opportunities. The paper explores Islamic finance as a way to contribute to the development and diversification of Egypt's financial services, increase financial inclusion and promote social equity, but also seeks to identify the challenges tailored to Egypt for such development.

Annexed to the paper are a number of very pertinent and relevant annexes that add to the understanding of this complex mode of finance. Appendix I is a detailed table of Islamic finance terms. Though Islamic finance in the U.S. is not substantial mostly when compared to other non-Muslim countries such as the United Kingdom, Appendix IV familiarizes us with Islamic finance in the U.S. and explains the approach taken by the US regulator. This was done upon a specific request by CASAR as it is within its broader scope of interest. Islamic finance in the U.S. does not seek to establish a separate regulatory framework to accommodate *Shari'a* rules; it rather seeks to check whether Islamic finance products are admissible within existing regulations and their potential interpretations. The resulting principle and practice is that most Islamic finance activities can develop with the framework of the existing regulatory framework. As for Appendix VI, which is most indicative for the way forward to Egypt's Islamic finance looks at topical issues based on the most recent news reports.

And, lastly I would like to thank Dr. Mohamed El-Komy, Assistant Professor of Economics at AUC and Dr. Ahmad Ghoneim, Associate Professor of Economics at the Faculty of Economics and Political Science, Cairo University for having kindly reviewed this paper from which the writer has mostly benefited and amended his paper accordingly. Once again, I would like to thank Dr. Wafik Grais, referred to by Dr. ElKomy and his colleagues as one of the few serious scholars in the field of Islamic finance, for his paper, which undoubtedly has enriched CASAR's research activities and website.

Content

Acronyms

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AfDB	African Development Bank
BIMB	Bank Islam Malaysia Berhad
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
BCPBS	Basel Core Principles for Banking Supervision
CG	Corporate Governance
CIBAFI	General Council of Islamic Banks and Financial Institutions
CIPA	Certified Islamic Public Accountant
EGP	Egyptian Pound
EMDB	Emerging Markets Data Base
FHLMC	Federal Home Loan Mortgage Corporation (Freddie Mac)
GCC	Gulf Cooperation Council
IFI	Islamic Finance Institution
IFIS	Islamic Finance Information Service
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IFS	Islamic Financial Services
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Markets
IOSCO	International Organization of Securities Commissions
IRTI	Islamic Research and Training Institute
IsDB	Islamic Development Bank
KFH	Kuwait Finance House
LUTH	Lembaga Urusan Tabung Haji
MENA	Middle East and North Africa
PLS	Profit and Loss Sharing
OIC	Organization of Islamic Countries
ROW	Rest of the World
SAMA	Saudi Arabia Monetary Authority
SME	Small and Medium Enterprises
SSB	*Shari'a* Supervisory Board
UAE	United Arab Emirates
USA	United States of America
USD	United States Dollar

Islamic Finance

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Wafik Grais

I. Introduction

Financial intermediation performs the functions of mobilizing financial resources from agents with surpluses and channeling them to those with deficits. In this process, it offers assets with different features of returns and security to surplus agents and screen deficit agents for their promise of security and return and monitors their performance. Financial intermediation can be indirect when financial organizations such as banks perform the function or direct when surplus and deficit agents are directly in contact through notably capital markets. In addition financial intermediaries perform payments and transfer and safeguard services, act as brokers, and monitor and control governance of businesses and markets. In performing those functions, financial intermediation can promote stability by ensuring sufficient liquidity where it is needed, foster sustainable development by funding activities pursuing that goal, and instill confidence by disclosing information and promoting transparency.[1]

Islamic finance performs the foregoing functions, complying with *Shari'a* requirements both in the nature of the assets it deals with and in the processes it follows. It is financial intermediation complying with a moral code of conduct based on *Shari'a* principles. Most notably, *Shari'a* prescribes fair contracts and proscribes speculation, core principles to Islamic finance. While *Shari'a* compliant finance dates back to the early days of Islam, it has experienced a new life since the nineteen sixties and a tremendous explosion since the beginning of the current millennium. It is now present across many nations where it represents a significant share of financial assets.

Islamic finance's renaissance did not escape international finance leaders' notice. Promptly, they understood its financial intermediation nature and the opportunities it offered for financial deepening, diversification and inclusion. For instance, in a 1995 speech, Lord Edward George, then Governor of the Bank of England recognized the 'growing importance of Islamic banking in the Muslim world and its

[1] Gorton and Winton (2002)

emergence on the international stage as well as the need to put Islamic banking in the context of London's tradition of "competitive innovation".[2] Other European countries have also identified the potential role of Islamic finance in their economies and made room in various ways for its introduction.[3]

In the USA, the country of entrepreneurship, financial entrepreneurs introduced Islamic financial products at both the retail and wholesale levels. They have succeeded in providing access to a pool of financial resources for business ventures, and offered profitable and secure *Shari'a* compliant placements to investors. They have also allowed many to have access to retail financial services such as mortgages, contributing to inclusion and welfare. USA Regulators have focused on the challenges of integrating Islamic finance in the mainstream of the country's financial system. Their focus on the economic substance of transactions rather than the formality of product structures facilitated market expansion notably of retail products. USA financial markets do mobilize Islamic financial flows and have often led the structuring of Islamic finance products.

The Egyptian financial system was an early mover in modern Islamic finance. The country offers ample investment opportunities that can attract Islamic financial placements and improve the country's development prospects. Islamic finance can rapidly grow beyond its current size of less than 5% of the country's financial assets. Islamic financial intermediation can contribute to deepening Egypt's financial system, increase the diversification of the services it offers, and improve financial inclusiveness.[4] It can offer opportunities for financing development whether at the state, corporate, small and medium enterprises or consumer levels. At the same time, Egypt's developmental needs and population's values offer promising prospects for Islamic finance. However, the introduction and development of Islamic finance raise challenges to market participants, policy makers, regulators, supervisors, as well as domestic and international standard setters. These challenges need to be addressed. Dealing with them in a professional and systematic way is the best warranty to ensure Islamic financial services success and deliver on the opportunity the industry provides for the country's development.

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2 September 1995, at a conference organized by the Islamic Foundation.

3For example, the German State of Saxony-Anhalt issued a Euro 100 mn *Ijara* based *Sukuk* in July 2004, the first issued by a non-Islamic sovereign. The *Sukuk* had a tenor of 5 years with the rate of return linked to the 6 month Euribor and paid a margin of 100 basis points over the benchmark. It matured in July 2009. See IIFM (200

4 See King and Levine (1993) for a seminal analysis of the impact of financial development on the economy. Also see Imam and Kopdar (2010): "Because Muslim populations are under banked, and given the tremendous need for infrastructure projects like roads and housing across the Muslim world, development of Islamic banking can spur growth in these regions and can be part of the solution to the slow development process".

The following highlights the recent history of Islamic finance, its core principles and modes of operations in section II. It then presents an overview of the broad landscape of Islamic financial intermediation in section III. Section IV deals with the opportunities Islamic finance offers to Egypt's development. The regulatory challenges Islamic finance faces are addressed in section V. A blueprint for an effective development of Islamic finance is suggested in section VI. Conclusions follow in section VII.

II. Recent History, Core Principles, Basic Operations

1. Recent History

Egypt holds a special place in the modern history of Islamic finance as its recognized birthplace. While Mit Ghamr may be known for being the center of aluminum production in Egypt, it is famous world wide as the place where the first Islamic bank was established in 1963. Then and there, Dr. Ahmad El Naggar established the Mit Ghamr savings bank that combined the idea of German savings banks with *Shari'a* principles. Though it did not carry the label of Islamic financial institution, the bank was the first *Shari'a* compliant one in modern times.[5]

However, the international development of Islamic finance was spearheaded by country authorities and financial entrepreneurs in Malaysia and the Gulf Cooperation Council (GCC) region.[6]

The authorities in Malaysia adopted a proactive policy to develop Islamic finance, notably in response to the country's Muslim community's aspirations. First, the Lembaga Urusan Tabung Haji (LUTH) was established in 1969 as a *Shari'a* compliant savings institution to support people going on pilgrimage to Mecca. The first Islamic bank, Bank Islam Malaysia Berhad (BIMB) was established later in 1983, licensed and regulated by Bank Negara Malaysia (BNM), the country's central bank. Bank Muamalat Malaysia Berhad (BMMB) was later in 1999. Malaysian authorities', in particular BNM's proactive policy led to the development of policies and regulations that enable a steady and sound development of the industry.

[5] IFIS Analytics (2008). See also Hanan I. El Naggar (2010) for a nice overview of the industry's history.
[6] It is relevant to note that according to some estimates, the world Muslim population is expected to reach 2.2 bn by 2030, an increase of 16% over the 1.9 bn of 2010. Currently, the Muslim world population may account for 7.7% of global GDP today.

In the GCC, a 1975 decree authorized the establishment of the Dubai Islamic Bank. Kuwait allowed the creation of the Kuwait Finance House (KFH) in 1977. In Bahrain and Qatar, Islamic banks were created in 1979 and 1982 respectively.[7] Of course, Saudi Arabia had Islamic finance but refrains from labeling financial activities as "Islamic"; the Saudi El Rajhi bank is GCC's largest Islamic bank.

While Egypt was a pioneer, a disorderly early development of Islamic investment companies under weak regulation and supervision led to the development and later collapse of finance houses, most notably the El Rayan Company. It was mobilizing depositors' resources offering highly attractive returns and claiming to be *Shari'a* compliant. In fact it did set up a Ponzi scheme that later collapsed in the late 1980s ruining many small depositors.[8] This episode stained the reputation of Islamic finance in Egypt and beyond, led authorities to remain skeptical on the potential benefits of Islamic finance and delayed its resurgence in the country. Cautiously authorities permitted the existence of the first Islamic financial provider, an Islamic window set up by Bank Misr, and the establishment of the first fully fledged Islamic bank, Faisal Islamic Bank in 1979. However, Egyptian authorities remained circumspect vis à vis Islamic finance for a very long time.

Various factors have contributed to the renaissance of Islamic finance. Imam and Kopdar (2010) find that the diffusion of Islamic finance is positively related to the relative size of Muslim population in a country, income per capita, hydrocarbon exports, political stability and trade relations with the Middle East. They also find a negative relationship between Islamic finance and interest rates.[9] Essentially their results point out the *role of champions and resource availability* in fostering Islamic finance's development. There is no doubt that the presence of *champions* has been instrumental in the renaissance of Islamic finance.[10] They have been prominent market participants like Dr. Ibrahim El Naggar in Egypt, or Mr. Salah Kamel and Prince Faisal in Saudi Arabia, founders of El Baraka and Faisal groups respectively. Champions have also been country authorities such as Malaysia's and Bahrain's

[7] Wilson R. (2009)

[8] See Securities and Exchange Commission on Ponzi Schemes: http://www.sec.gov/answers/ponzi.htm. A TV series on the El Rayan episode is due to be aired on Egyptian TV during the month of Ramadan of 2012. See The Egyptian Gazette, July 5, 2012, http://213.158.162.45/~egyptian/index.php?action=news&id=20552&title=El-Rayan%20drama%20makes%20waves

[9] Imam and Kopdar (2010) focus on the diffusion of Islamic banking. They find that "the probability for Islamic banking to develop in a given country rises with the share of the Muslim population, income per capita, and whether the country is a net exporter of oil. Trading with the Middle East and economic stability also are conducive to diffusion of Islamic banking. Proximity to Malaysia and Bahrain, the two Islamic financial centers, also matters. We found that rising interest rates hinder the diffusion of Islamic banking because they raise the opportunity cost for less devout individuals or non Muslims to put their money with an Islamic bank".

[10] Champions mentioned here are provided as examples. These references do not diminish in any way the extraordinary role played by other champions whether at the individual or institutional levels in national and international contexts.

central bank governors, most notably, Dr. Zeti Akhtar Aziz and Mr. Rasheed Mohammed Al Maraj respectively, or the founders of the Islamic Development Bank (IsDB), in particular Saudi Arabia. One has also to acknowledge the role played by leaders of organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB) or International Islamic Financial Markets (IIFM).[11] They endeavored to lay the ground rules for the industry and to harmonize them across countries. Champions' efforts were facilitated by *resource availability* or hindered by the lack thereof. The international wealth redistribution that occurred in the wake of increases in hydrocarbon prices in the early nineteen seventies, early ninety eighties, and later after a lull, enabled champions notably in the GCC region to develop Islamic financial services. The presence of hydrocarbon resources was also a factor in Malaysia but to a lesser extent. Clearly, resource availability was less of a factor in the initial renaissance of Islamic finance in Egypt, but later played a role due to the country's close geographical and cultural connection with the GCC countries.

The role of interest rates is pointed out by Imam and Kropdar as a factor influencing the industry's development. The point confirms the financial intermediation nature of Islamic finance implying that agents do consider relative returns offered by Islamic and conventional financial services. Also, it is worth noting that periods of financial crisis, and distress occurrences of Islamic financial institutions, slow down the industry's expansion. For example, the international financial crisis over 2007 and 2008 slowed down the issuances of *sukuks* as well as the engagement of large international banks in Islamic finance.[12] Similarly episodes of collapse of Islamic finance institutions have hurt confidence in the industry and sometimes slowed temporarily its development.[13]

2. Core Principles and Operations Primer

An often raised question is what actually is Islamic finance and in what way does it differ from conventional finance? Islamic financial services pledge to conduct financial intermediation in accord with a code of behavior based on Islamic values. The code's principles are enshrined in the contracts and

[11] Other organizations were also established.

[12] The slowdown of issuance of *sukuks* resulted also from a revisiting of the *Shari'a* compliance of previously issued *sukuks* by AAIOFI's *Shari'a* board. Islamic banks seem to have better weathered the adverse impact on profitability of the international financial crisis in 2008. Their credit and asset growth performed better than did that of conventional banks over 2008–09. External rating agencies' assessed Islamic banks generally more favorably. See Hasan and Driri(2010). See also page 15 below and footnote 27.

[13] As the collapse notably of Ryan finance house in Egypt demonstrates, whatever were its reasons. See also for example Starr and Yilmaz (2007) for a Turkey 2001 distress episode. The issue is the importance of the "reputation" risk for the finance industry.

product offerings. It happens to use the word "Islamic" to characterize its observance of the code. Possibly for that reason, in the current international context, it gathers champions and advocates, attracts many who see in it merely a business opportunity; it raises open as well as silent, sometimes vehement opposition; it often leaves many puzzled on its nature and value added. This leads to unnecessary mystification and often poorly based judgments. Better knowledge of principles the sector pledges to observe, industry's compliance with markets' demand of transparency and truth in advertisement, and finally market developments can promote balanced views and effective dialogue. It can help assess the potential contribution of the sector to development, in a professional way.

At its core, Islamic finance is a behavior in conducting financial businesses. In particular that behavior endeavors to have fair contracts and mitigate risks resulting from speculation. It is ethical finance with a defined source of ethics. While the devil is in the details and there are obviously differences across scholars, Islamic financial services may be seen as grounded in five basic principles: a) prohibition of *riba* ;[14] b) risk-sharing—the terms of financial transactions need to reflect a symmetrical risk/return distribution each party to the transaction may face; c) materiality—a financial transaction needs to have a "material finality", that is, it is directly or indirectly linked to a real economic transaction;[15] d) no exploitation—a financial transaction should not lead to the exploitation of any party to the transaction;[16] and e) no financing of activities deemed to be harmful to society, such as the production of alcoholic beverages. Financial intermediation consistent with these five principles would be consistent with the pledged code of conduct.

Islamic finance has developed on the basis of the foregoing principles. They have led Islamic banks to adopt the type of balance sheet stylized in Box 1. The *risk sharing* is enshrined in the use of the *mudaraba* contract. It is a contract between an owner of financial resources (*rabu el mal*) and someone who takes charge of managing them (*mudarib*) on behalf of the owner for a fee and a share of profit. This type of contract is extensively used in deposit taking where the bank is the manager of the resources and the depositor, the owner. It can also be used in extending financing by the bank to an economic agent or entrepreneur with the bank taking this time the role of owner and the entrepreneur

[14] This term literally means an increase or addition and is recognized in Islamic jurisprudence to encompass both the notions of usury and interest. Any risk-free or "guaranteed" rate of return on a loan or investment is considered *riba* and therefore prohibited. The prohibition extends to *gharar* (large uncertainty entailing contractual ambiguity), *maysir* (taking excessive risk like in speculation or games of chance).
[15] "Materiality need not be a one to one tight correspondence between the real economic transaction and the financial one.
[16] No exploitation entails no information asymmetry between the parties to the contract and requires full disclosure of information.

that of resource manager. Under that type of contract the bank, "owner" of the funds does not intervene in the management of the funded project. In a *mudaraba* contract, the bank is entitled to receive from the entrepreneur the principal of the sum it "invested" at the end of the period stipulated in the contract, if and only if, profits have accrued. If, on the contrary, the enterprise's books showed a loss, the bank would not be able to recover its investment. For understandable risk management reasons, *mudaraba* is not an IIFS' preferred contract for funding risk bearing assets.

Musharaka contracts provide a better opportunity than *mudaraba* to monitor and control projects funded by the Islamic bank. Indeed, in a *musharaka*, the bank becomes an active shareholder of the project and all partners may concur to the management of the enterprise and hold direct voting rights. *Musharaka* contracts are not extensively used by Islamic banks because of their generally longer maturity and the weak institutional infrastructure found in many jurisdictions where Islamic finance is present and similarly limits the development of conventional equity financing.

The *materiality* principle leads to the financing by the bank of a real economic transaction for the account of the economic agent needing the financing. Materiality is intrinsic to the *ijara* or leasing contracts as well as to the *murabaha*. The latter is essentially trade finance where the financier purchases the needed commodity for the account of the financed that takes spot delivery, and pays back the financier with a mark up, at a later date.

The *prohibition of riba* excludes the payment of interest to the *amana* depositor, basically a demand depositor who needs the guarantee of his principal and foregoes remuneration for that. The *mudaraba* depositor on the contrary, may enjoy the opportunity of a return but also face the risk of a loss.[17] *Amana* deposits' face value is guaranteed. They are redeemable on demand.

The no exploitation includes also the idea of no excessive risk taking, or risk taking in the nature of gambling. It also covers issues of asymmetric information as benefiting from non shared information entails an unfair contract and consequently exploitation. The prohibition of financing of harmful activities is self explanatory.

[17] The prohibition of payment and receipt of a fixed or predetermined rate of interest is replaced by profit and loss sharing (PLS) arrangements where the rate of return on financial assets held in banks is not known and not fixed prior to the undertaking of the transaction. The actual rate of return can be determined on the basis of actual profits accrued from real sector activities that are made possible through the productive use of financial assets.

In principle, the combination of risk-sharing and prohibition of *riba,* entails profit and loss sharing arrangements and a balance sheet structure as in Box 1.[18] It should limit the impact of external shocks on Islamic banks balance sheets. Indeed, their balance sheet incorporates an intrinsic hedge in principle, as a loss of asset value would translate in change of value of the pool of resources that funded it, generally mostly investment accounts. Islamic banks pool depositors' funds in providing them with professional investment management with associated returns and risks. Neither the face value of investment deposits nor their return is guaranteed. Investment depositors share in the bank's net profit (or loss) according to the Profit and Loss Sharing (PLS) ratio stipulated in their contracts. From the perspective of investment account holders, Islamic banks behave like mutual funds with a variable net asset value.

Box 1 **Stylized Balance Sheet of an Islamic Bank**

(A) Theoretical Balance Sheet of an Islamic Bank Based on Maturity Profile

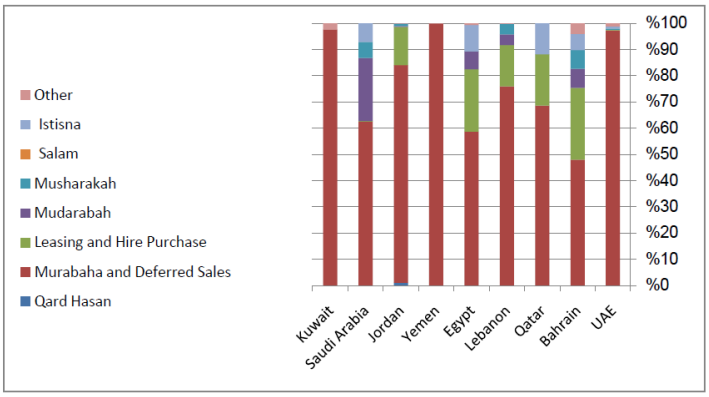
Assets	Liabilities
Short-term trade finance (cash, *murabaha, salam*)	Demand deposits (*amana*)
Medium-term investments (*ijara, istisna*)	Investment accounts (*mudaraba*)
Long-term partnerships (*musharaka*)	Special investment accounts (*mudaraba, musharaka*)
Fee-based services (e.g. *kifala*)	Reserves
Non-banking assets (property)	Equity capital

(B) Theoretical Balance Sheet of an Islamic Bank Based on Functionality

Assets	Liabilities
Cash balances	Demand deposits (*amana*)
Financing assets (*murabaha, salam, ijara, istisna*)	Investment accounts (*mudaraba*)
Investment assets (*mudaraba, musharaka*)	Special investment accounts (*mudaraba, musharaka*)
Fee-based services (e.g. *kifala*)	Reserves
Non-banking assets (property)	Equity capital

Source: Z. Iqbal and H. Van Greuning (2008)

Figure 1 ***Murabaha* and *Ijara*: Dominant Modes of Financing** (2008)



Source: Aly, Salman Syed (2011)

[18] See Usmani (2002), for the different modes of financing appearing in Box 1

Fiduciary responsibility, regulatory and supervisory requirements, and risk management have led to a dominance of *murabaha* and *Ijara* modes of financing in Islamic banks' balance sheets (Figure 1). One could have expected *mudaraba* and *musharaka* to take a larger place because of their risk sharing features, core to Islamic finance. Mitigation of these risk sharing features require evolved contractual, legal and conflict resolution arrangements. However, though progress has been achieved, these are often weak in many countries and accordingly the development of equity markets and *mudaraba* and *musharaka* transactions has been slow.

III. Market Landscape : Significant Broad Based Presence

Today, Islamic finance is present in more than 75 countries, with worldwide assets in excess of a trillion US dollars.[19] While only Iran and Sudan have fully Islamic financial systems, Islamic finance holds significant market shares in many countries, close to 50 percent in some cases. Islamic finance has diversified within and beyond banking into capital markets and insurance, and other non banking services. In parallel, the industry is now endowed at both country and international levels with an enabling regulatory framework supporting its development. Notably, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) have successfully developed various standards for the industry. The Islamic Development Bank (IsDB) is playing a central role in fostering the industry's expansion and providing Islamic financing for development in members of the Organization of Islamic Countries (OIC).

1. Islamic Finance Landscape Overview

Islamic financial assets are concentrated in the GCC, Iran and Malaysia. The rest of the world weight is about that of Malaysia. Out of the estimated USD 1.13 trillion worldwide Islamic assets in 2010, the largest amount was held in the Islamic Republic of Iran. They represented around a third of international holdings at USD 406bn. The Kingdom of Saudi Arabia's and Malaysia's financial systems had USD 177 bn and USD 120 bn Islamic assets respectively, representing the second and third largest domiciliation of Islamic finance in terms of size of assets. The GCC, including Saudi Arabia has the largest value of Islamic financial assets, ahead of Iran. Malaysia and the rest of the world have each about the same size of

[19] Alone, assets under management with mutual funds amounted to USD 25.6 trillion at the end of the first quarter of 2011 according to Ernst and Young (2011)

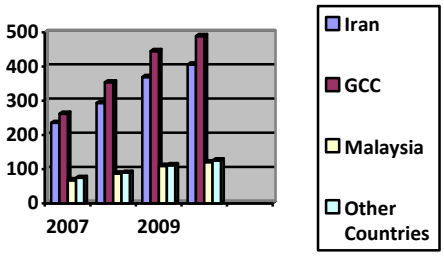
Islamic financial assets, in the order of USD 120 bn (Table 1, Figure 2). Interestingly, Islamic financial assets had reached USD 27 bn in the UK in 2010, placing the country 8th in terms of assets size.

Table1 Islamic Financial Assets Domiciliation

	Country/Region	2007	2008	2009	2010
1	Iran	235	293	369	406
2	GCC	262	354	445	489
3	Malaysia	67	87	109	120
4	Other Countries	74	89	111	125
	Total	638	823	1034	1140

Source: Author's calculations from Dar, H. and Azami Talha Ahmed, editors (2011)

Figure 2 Islamic Financial Assets Domiciliation



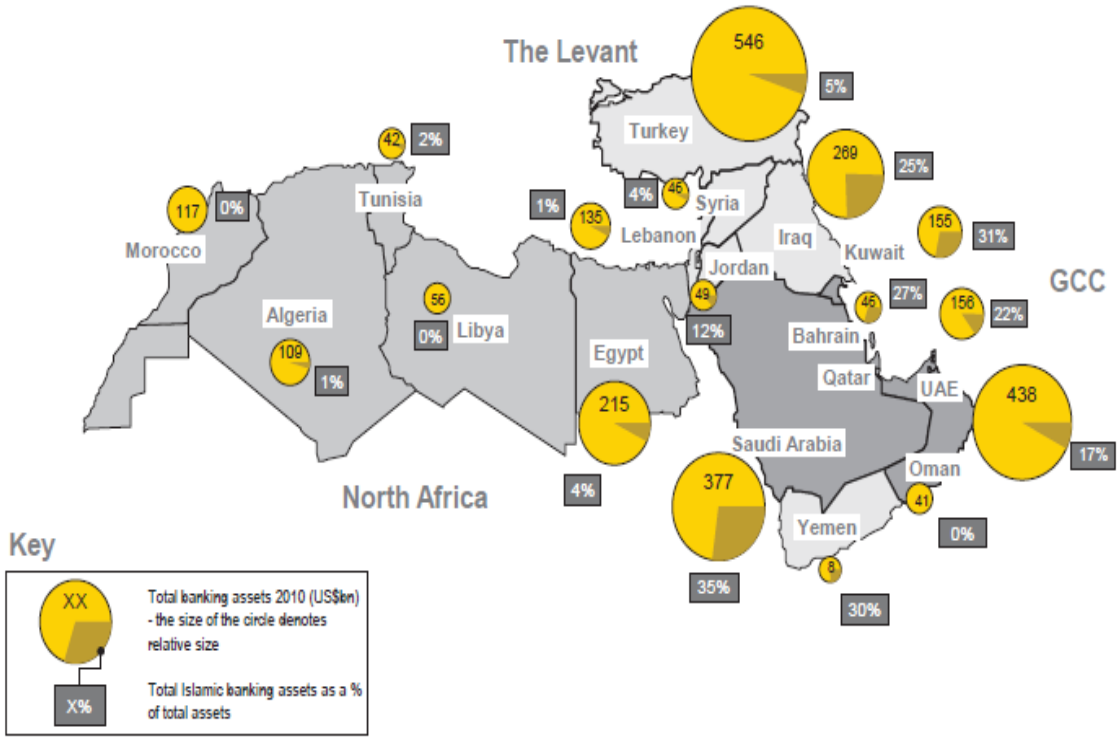
Within the Middle East and North Africa (MENA), GCC countries have been at the forefront of the development of Islamic finance, in terms of number and size of banks, size of *sukuks* issuance and development of institutional infrastructure. GCC Islamic financial institutions have also led the development of the industry in other countries of the region notably through the establishment of local subsidiaries or acquisition of domestic ones.[20] Interestingly, the presence of Islamic finance seems to decrease from the GCC region to the shores of the Atlantic Ocean, as one moves westward.[21] Egypt and the other North African countries are lagging behind on most aspects.

While Islamic finance assets account for 46% of Bahrain's financial assets and have a significant share in other GCC countries except Oman, they hardly reach 5% in the rest of the MENA region, except in Irak and Jordan (Figure 3). West of Egypt whose Islamic financial assets are around 5%, the largest share (2%) is in Tunisia; it is otherwise negligible.

Egypt now has 14 Islamic banking licenses of which three full-fledged Islamic banks, such as Faisal Islamic Bank of Egypt, and several with Islamic windows, including National Bank of Egypt and Ahli United Bank.[22] The roughly 200 branches and 120 billion Egyptian pounds of assets in Egypt's Islamic banking industry are dwarfed by Egypt's conventional banks. Total assets of the entire banking sector are about 1.3 trillion pounds, the latest central bank data show.[23]

[20] GCC Islamic finance institutions have also established subsidiaries beyond the MENA region, notably in South and South Eastern Asia.
[21] An exception in the GCC is the Sultanate of Oman where Islamic finance had a late start.
[22] Part of Bahrain's Ahli United Bank group
[23] See IFIS June 12, 2012 "Egypt Islamists draft code to boost Islamic banks"

Figure 3 MENA Financial Landscape



Source: Ernst and Young (2011)

2. Beyond banking: *Sukuks*, Funds

Islamic finance has diversified beyond basic banking services notably into capital markets and fund management, though it is still largely dominated by banking (Table 2).[24]

Table 2 Distribution of Islamic Finance by Assets' Classes
(USD bn)

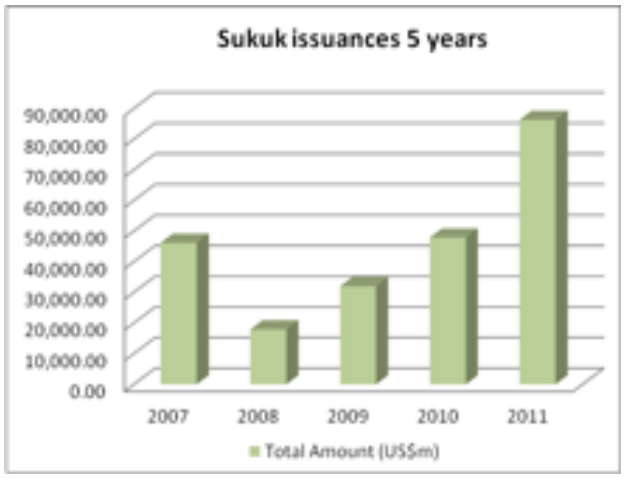
	2008	2009	2010	2011*
Banks	800	863	1048	1200
Funds	51	54	58	60
Takaful	8	13	21	25
Others	1	3	3	4
Total	860	933	1130	1289

*UKIFS estimate
Source: The Banker, Ernst and Young, from UKIFS (2012)

[24] Takaful is another significant segment of Islamic finance. It has made inroads also in Egypt and could fill a very important service gap that conventional insurance has not yet managed to cover. Takaful companies in Egypt may hold 5% of the Egyptian insurance market. See IFIS (2010)

Though *sukuks* represent less than 8% of Islamic financial assets, the expansion of the *sukuks* market has been a major development.[25] There were 803 issues of *sukuks* for more than USD 92.6 bn in 2011.[26] *Sukuks* have provided sovereigns and corporations with access to a pool of resources whose owners seek *Shari'a* compliant placements. There are various types of *sukuks*. They differ by the type of the underlying Islamic financial transaction and the general purpose of its use. The first *sukuk* was issued by a non-Islamic company, Shell Malaysia, in Malaysia in 1990. It was a Ringgit denominated issue with a modest size of approximately USD 30 mn and based on the principle of *Bai' Bithaman Ajil*, or deferred payment sale. Since then the market has grown with issues expected to reach around USD 100 bn in 2012 in spite of a slowdown in 2008 in the wake of the international financial crisis and a pronouncement of AAOIFI's *Shari'a* board on *sukuks'* compliance with *Shari'a*.[27]

Figure 3



Source: IFIS data base

In contrast to the global domiciliation distribution of Islamic financial assets where Iran and the GCC dominate, *sukuks*' issuers have largely been from outside the major Islamic finance centers. More than 50% of the amounts issued over 2009-2011 was outside Iran, the GCC countries and Malaysia. Within traditional Islamic financial centers, Malaysia has clearly been in the lead with issuance to date for 2012 amounting to 59% of the total amounts raised. Worldwide sovereigns and quasi sovereigns have been the major issuers of *sukuks* with a share exceeding 70% of the total amounts issued. Corporations'

[25] See AAOIFI's definition: "Certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity". (Page 298 of AAOIFI's *Shari'a* Standards for Financial Institutions 2004-5). See

[26] IFIS data base

[27] See AAOIFI *Shari'a* board on sukuks: http://www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf

shares of *sukuks* issued have generally been less than 30%. Within corporate issues, Malaysia and the rest of the world (ROW) have been active at more or less similar levels.

Within the MENA region, the GCC countries have dominated the *sukuks* market while Iran has a negligible presence. The share of the value of the *sukuks* issued in the GCC is reaching 15% of total issues for 2012, or close to USD 12bn. Sovereigns and quasi sovereigns capture the largest share of the value of issued *sukuks*, in line with the global pattern.

So far *sukuks* have been issued by corporations in Egypt and interestingly have been denominated in EGP. There have been three *sukuk* issuances in EGP worth a total of USD 100.4 mn, by Egypt's El Tawfeek group in 2010.[28] Still in 2010, El Baraka Egypt announced a USD denominated issue worth USD 150mn. However the number of announced *sukuks* issuance and their value has increased since 2011 with denominations of USD and EGP. The AMER group has announced two EGP issues worth USD 447mn. Moreover, the transitional government had announced the intention of issuing a sovereign *sukuk* for an amount of USD 2bn. If all these issues materialize, Egypt would have issued the equivalent of almost USD 2.7 bn marking a significant broadening of its sources of finance at the corporate and sovereign levels.

Besides *sukuks*, non banking Islamic finance has seen a significant growth in Islamic funds. Assets under management stood at USD 58 billion in 2010.[29] While assets under management in the global industry fell in the wake of the crisis, Islamic funds continued to grow at a modest pace in numbers and size of assets.[30] However, institutional investors remain the dominant investors in Islamic funds contributing about 70% of assets under management versus 30% for retail investors.

[28] Of this amount, USD two issues valued at about USD 47 mn have been redeemed.
[29] See Ernst and Young (2011)
[30] Assets under management in the global funds' industry recovered significantly from the USD 18 trillion trough of 2008 and reached USD 25.6 trillion in 2010. See Ernst and Young (2011)

Table 3 *Sukuk* Issues

	Issued Sukuks (USD mn)				Issued Sukuks			
	2012	2011	2010	2009	2012	2011	2010	2009
Total	**80,781.65**	**92,575.07**	**54,862.23**	**40,996.72**	**100%**	**100%**	**100%**	**100%**
Iran		183.87			0%	0.2%	0%	0%
GCC	11,889.93	13,084.93	2,916.59	3,779.84	15%	14%	5%	9%
Malaysia	47,596.24	26,453.66	19,052.56	16,143.27	59%	29%	35%	39%
ROW	21,295.48	52,852.61	32,893.08	21,073.61	26%	57%	60%	51%
Corporate	**24,325.95**	**20,803.29**	**11,581.93**	**6,731.52**	**30%**	**22%**	**21%**	**16%**
Iran		183.87			0%	1%	0%	0%
GCC	1,373.14	1,747.00	0	393.3	6%	8%	0%	6%
Malaysia	18,178.81	9,443.68	5,844.77	1,949.94	75%	45%	50%	29%
ROW	4,774.00	9,428.74	5,737.16	4,388.28	20%	45%	50%	65%
Sovereign and assimilated	**56,455.70**	**71,771.78**	**43,280.30**	**34,265.20**	**70%**	**78%**	**79%**	**84%**
Iran		0			0%	0%	0%	0%
GCC	10,516.79	11,337.93	2,916.59	3,386.54	19%	16%	7%	10%
Malaysia	29,417.43	17,009.98	13,207.79	14,193.33	52%	24%	31%	41%
ROW	16,521.48	43,423.87	27,155.92	16,685.33	29%	61%	63%	49%

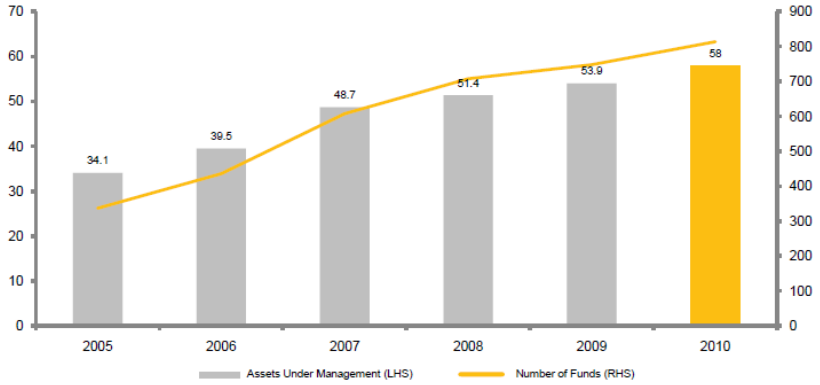
Source: IFIS data base and author's calculations

Table 4 Egypt *Sukuk* Issues

Date	Issuer	Domicile	Currency	Status	Type	US$m	Arranger	Maturity
5/28/2012	Amer Group Holding (AMER)	Egypt	EGP	Announced	NA	197		NA
5/28/2012	Amer Group Holding (AMER)	Egypt	USD	Announced	NA	250		NA
2/8/2012	Ministry of Finance (Arab Republic of Egypt)	Egypt	USD	Announced	NA	2000		NA
11/1/2010	Al Baraka Bank Egypt	Egypt	USD	Announced	NA	150		NA
7/10/2010	Al-Tawfeek for Securitisation Company S.A.E.	Egypt	EGP	Outstanding	Ijara	52.99	CIB	7/10/2013
6/10/2010	Al-Tawfeek for Securitisation Company S.A.E.	Egypt	EGP	Redeemed	Ijara	40.62	CIB	7/10/2011
6/10/2010	Al-Tawfeek for Securitisation Company S.A.E.	Egypt	EGP	Redeemed	Ijara	6.8	CIB	6/10/2011

Source: AfDB (2011) and IFIS data base

Figure 4 Islamic Funds Growth



Source: Ernst and Young (2011)

Managed Islamic mutual funds face the challenge of screening the assets to include in their portfolio to generate returns, like their conventional counterparts. However, in addition, they need to ensure that the assets in their portfolio are *Shari'a* compliant. First, one can note that certificates of equity mutual funds are intrinsically more compliant than bank deposits. The former by construction do not have a guaranteed face value as they are marked to market, while the nominal value of bank deposits is guaranteed. Accordingly mutual funds certificates can fit more easily in an Islamic finance framework. Second, however, Islamic mutual fund managers need to adopt another screening layer to ensure the portfolio's *Shari'a* compliance (Table 5).

The largest number of Islamic funds is domiciled in Malaysia and the GCC countries, particularly Saudi Arabia. However, off shore centers continue to attract a large number of Islamic funds for their domiciliation. More than 50% of Islamic funds are equity funds, investing in shares of *Shari'a* eligible companies.[31] These types of funds are intrinsically *Shari'a* compliant as they combine both materiality and risk sharing aspects. In addition, they can mitigate or even eliminate *haram activities* and *riba* through their screening of companies eligible to be invested in.[32] Islamic equity funds mobilize resources through *mudaraba* contracts and take shareholding participation (*musharaka*) when they invest.

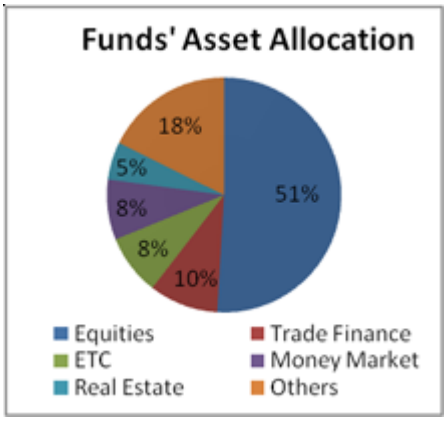
[31] Ernst and Young (2011) assesses the share of Islamic equity funds at 39%
[32] Abul Hassan, Antonios Antoniou (2007)

Table 5 Financial Ratios of Alternative *Shari'a* Screens

Screens / *Ratios*	DJIM	FTSE***	S&P	MSCI **	HSBC	Meezan Bank
	Liquidity Ratios					
Account Receivables, Cash and Short term Investments over Total Assets					50%	
Account Receivables and Cash over Total Assets		50%				
Account Receivables over Total Assets				70%		
Account Receivables over Market Cap	33%		49%			
Interest Income Ratios						
Total interest Income over Total Revenue*		5%			5%	5%
Cash and Short term Investments over Market Cap	33%		3%			
Cash and Short term Investments over Total Assets		33%		33.33		
	Indebtedness Ratios					
Total Debt over Total Assets		33%		33.33%	30%	
Total Debt over Total Market Cap	33%		33%			30%
	Permissible Income					
Non Interest, Non Permissible Income		5%	5%			
Total investments in non permissible income over market cap						30%

Source: Derigs and Marzban (2009); (*) For Meezan Bank the limit of 5% applies to interest and non permissible income see Usmani, M.I.A.(2002); (**) http://www.mscibarra.com/products/indices/islamic/; (***)http://www.ftse.com/Indices/FTSE_Shariah_Global_Equity_Index_Series/index.jsp

Figure 5



Source: IFIS data base

Egypt based capital management companies have been active in setting up Islamic funds (table 5). With one exception, they are all equity funds reflecting the stage of development of the country's stock exchange.[33] All these funds are open ended allowing investors to come in and withdraw at their

[33] Also equity stocks represent around 70% of trade value with bonds accounting for the remaining 30%. See IFIS (2011)

discretion. The funds' net asset value varies with performance of the shares in their portfolio on the stock market. Islamic funds enlarge the menu of placements for private wealth management and should contribute to enhance stock markets development.

Table 6 Islamic Funds in Egypt

Date	Fund Name	Asset Type	Currency	Fund Size	Fund Manager	Type
1/24/2012	Hilal Fund- Egypt	Equities	EGP	N/A	Cairo Capital Group	Open Ended
8/18/2011	Al Wefak Fund	Equities	EGP	N/A	HC Securities & Investment	Open Ended
7/21/2011	Naeem Egypt Islamic Fund	Equities	EGP	N/A	NAEEM Financial Investments	Open Ended
10/17/2010	Al Hayat Fund	Equities	EGP	N/A	NBK Capital Asset Management Egypt	Open Ended
8/10/2010	Al Baraka Islamic Fund (Al Mutawazin)	Mixed Assets - Balanced	EGP	6.79	AT - Asset Management	Open Ended
2/10/2008	Bashayer Mutual Fund	Equities	EGP	42.51	National Fund Management Co	Open Ended
1/8/2007	Sanabel Islamic Investment Fund	Equities	EGP	23.46	HC Securities & Investment	Open Ended
10/24/2006	Banque Misr Islamic Fund (Al Hessn)	Equities	EGP	31.14	HC Securities & Investment	Open Ended
10/1/2006	Al Aman Fund	Equities	EGP	N/A	CI Asset Management	Open Ended
6/1/2006	Al Baraka Bank Mutual Fund	Equities	EGP	22.91	EFG Hermes (Egypt)	Open Ended
12/1/2004	Faisal Islamic Bank of Egypt Mutual Fund	Equities	EGP	47.89	EFG Hermes (Egypt)	Open Ended

Source: IFIS data base

3. Institutional Infrastructure

The regulatory arrangements and institutional infrastructure supporting Islamic finance has come a long way, but is still evolving. It varies across jurisdictions. Some countries have enacted separate Islamic banking laws.[34] Others extend the general banking law to Islamic banks. Sometimes a special law is enacted for the establishment of a specific institution. In other cases, Islamic banks' specificity is devolved to regulators' purview and managed through regulatory acts and circulars. Heretofore, Egypt had no general law for Islamic banks. It dealt with them through tailor made legislation for specific institutions or regulations, under the general umbrella of the banking law and the supervision of the central bank.

[34] Archer & Ahmed (2003), IRTI et al (2007).

Internationally, attention has been given since the early 1990s to the prudential framework governing Islamic Financial Institutions. For example, differences between Islamic and conventional banks balance sheet structures, features of Islamic financial contracts, and associated risks have been recognized to have important implications notably for accounting and financial reporting. Under the leadership of the IsDB and a number of central banks, standard setting bodies have been established to address these types of issues. Bahrain-based AAOIFI was established in the early nineties. It focuses on accounting, auditing and *Shari'a* standards, and has taken a lead role on these matters, notably issuing standards, and organizing training. Its standards have been adopted by a number of Islamic finance institutions and countries, and are used as a reference when conventional national rules are deficient for Islamic financial transactions in other jurisdictions.

In November 2002, a group of central banks established the Islamic Financial Services Board (IFSB) with headquarters in Kuala Lumpur. The IFSB has developed international standards notably on capital adequacy, risk management, corporate governance, transparency, and market discipline and supervision. It has also provided guidance principles for systemic liquidity management. It is paying attention to prudential arrangements governing other Islamic finance non-banking activities including takaful standards as well as legal risks. Like AAOIFI's, IFSB's standards do provide references for national regulatory arrangements.

Similarly the IIFM focuses on the standardization of Islamic financial instrument structures, contracts, product development and infrastructure; and the issuance of guidelines and recommendations for the enhancement of Islamic capital and money market globally. In addition, these international bodies provide a useful interface with global organizations focusing on conventional finance such as the International Accounting Board, Basel Committee for Banking Supervision, or International Organization of Securities Commissions (IOSCO). With the AAOIFI, IFSB, IIFM and various national efforts aimed at providing a framework governing Islamic financial intermediation, the essential building blocks for the formulation and implementation of public policy are coming into place, though still evolving.

Rating agencies are also focusing on IFS as well as Islamic capital market instruments. They have developed approaches to assessing Islamic financial institutions' risks as well as rating *sukuks*. They also

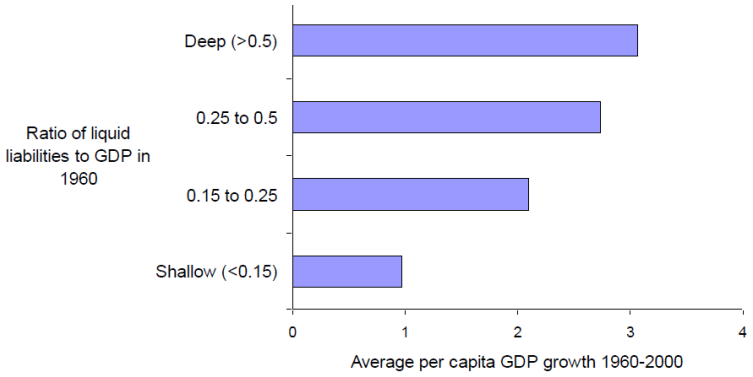
have focused on legal risks issues, related notably to dispute settlement.[35] Prominent Islamic financial institutions such as the IsDB, Al Rajhi, or Kuwait Finance House (KFH) receive ratings. The gradual involvement of rating agency has led to the rating of *sukuk* issues and brought a degree of direct market discipline. Malaysia's global *sukuk* and the Kingdom of Bahrain *sukuk* notes were among the first to be rated in 2002. The increased number of ratings helps mainstream Islamic financial services, increase confidence and limit spreads. More than half of the corporate *sukuks* issued in the first half of 2007 are rated.[36]

IV. Islamic Finance: Opportunity to Finance Egypt's Development

Countries with deeper financial systems achieve higher economic growth rates (figure 6). Also inclusive financial systems that permit access to financial services to more people and companies promote social inclusion and equity.[37] While Egypt has made significant progress in deepening and developing its financial sector, it has still some way to go in terms notably of increased depth, diversification of services, regulatory and supervisory arrangements. Moreover, financial inclusion remains limited with notably only 44 % and 8.5% of adult population having a deposit bank and loan account respectively.[38] Furthermore access to insurance services, most notably life insurance remains limited (Table 7). The development of *takaful* could help expand these services, improve risk management for businesses and individuals, encourage entrepreneurship and enhance intergenerational equity.[39] Thus further development and diversification of financial services can foster a healthy economy and equitable society. Islamic finance can contribute to the development and diversification of Egypt's financial services, increase financial inclusion and promote social equity.[40] The following highlights Islamic finance potential contribution to households, project, corporate and SMEs financing.

[35] FitchRatings (2005), FitchRatings (2007), Moody's (2006), Standard and Poor's (2006)
[36] IFIS website, August 15, 2007
[37] See e.g. Honohan (2004a)
[38] Reported in Pearce (2011) Annex I.
[39] For example, Arena (2006) reports: "Using the generalized method of moments for dynamic models of panel data for 56 countries and for the 1976-2004 period, we find robust evidence of a causal relationship between insurance market activity and economic growth".
[40] See Pearce (2011) that reports that an IFC-commissioned market studies in the MENA region found that "between 20 and 60 percent of those interviewed (microenterprises, low income individuals) indicated a preference for *Shari'a* compliant products. For some the lack of *Shari'a* compliant products is an absolute constraint to financial access, while for others this is a preference and they continue to use conventional financial services in the absence of competitive Islamic ones".

Figure 6 Financial Deepening and GDP Growth



Source: Honohan (2004b)

Table 7 Insurance Penetration

(% of GDP)

	Non-Life Premium	Life Premium	Assets
Egypt	0.42	0.37	3.9
High Income OECD	2.3	4.0	45
East Asia and Pacific	0.97	2.8	4.9

Source: Lester (2010), based on AXCO reports, Swiss Re. Sigma, IMF/World Bank databases, National sources

4. Households' Finances

A performing financial system should provide households with the services to: i) efficiently settle their financial transactions, ii) manage their lifelong finances and ii) cope with unanticipated adverse events without facing catastrophic consequences. Islamic finance can contribute notably in two ways. It can offer financial services needed to households that do not wish to deal with conventional finance, and diversifying the menu of available financial services. Thus, Islamic finance can enhance financial inclusion as it allows more Egyptian households to find services consistent with their religious beliefs. Moreover Islamic finance can make available to all households a larger menu of financial services allowing them to more efficiently settle financial transactions, manage their lifelong finances and cope with unanticipated adverse events.

The availability of *amana* and *investment* accounts can provide households with instruments to conduct their current financial transactions and hold some of their savings. Islamic funds can provide other

placement opportunities to retail investors and contribute to capital markets vibrancy. Similarly, Islamic financial institutions can extend *murabaha*, *ijara* or *musharaka* for instance to support households acquire durable goods and equipment as well as finance mortgages to enlarge access to housing ownership. Without the availability of these resources, many households would remain outside the financial system entailing a loss of welfare, drag on economic growth, and a missed opportunity for social inclusion. Besides, these services can be available to all groups of society irrespectively of their religious affiliation, enlarging the menu of financial services.

2. Financing Corporations and Projects

In the normal course of business corporations have recourse to financial facilities to fund their short term needs or longer term investments, to manage invoices, or extend financing to clients. Islamic finance can provide resources to enable corporations conduct these activities. However, generally these corporate finance decisions have been based on analyses where interest rates play a critical role. Accordingly, corporations that seek to access Islamic finance need to recast their operations and decisions on a framework that is *Shari'a* compliant. Similarly Islamic finance providers are constantly innovating to offer their corporate clients facilities that suit their needs and are *Shari'a* compliant. In addition advisory services are available to support firms making their financial management *Shari'a* compliant.[41]

Economic growth is driven by investments in projects, most notably in infrastructure. Because of their "material" nature, these activities are particularly suited to Islamic finance. These projects are funded on various degrees of possibilities of recourse to the balance sheet of the sponsor. Egypt has benefitted from Islamic finance for a number of projects, principally supported by the IsDB and mostly based on *ijara* operating leases or *murabaha* contracts.[42] The IsDB was the financier for the three *ijara* deals and the government the funding recipient. In the case of the Benha Power Plant, the government of Egypt rents the facilities from the IsDB from the fourth year after the project is completed with revenues from the sale of the electricity. The *ijara* rents are paid over a 15 year period to the IsDB, after which the government purchases the plant. Islamic funding in the form of *mudaraba* was made available for the Abu Qir Power plant from the Faisal Islamic Bank of Egypt. The *mudaraba* facility provided partnership

[41] See for example Ayub (2007)
[42] See AfDB (2011)

finance in return for a share of the profits accruing to the West Delta Electricity Company. It was part of a syndicated financing deal arranged by the Arab African International Bank. [43]

Table 8 Islamic Project Finance in Egypt

Date	Project	Sector	Financial Instrument	Amount (USD mn)
January 2011	Saudi Al Batterjee	Hospital	Ijara	10.0
January 2011	Suez Steam Power	Energy	Ijara	60.0
September 2010	Benha Power Plant	Energy	Ijara	120.0
December 2009	ENPC Fertilizers	Manufacturing	Murabaha	15.0
October 2009	Abu Qir Power	Energy	Mudaraba	73.8

Source: AfDB (2011) based on IFIS

3. SMEs financing

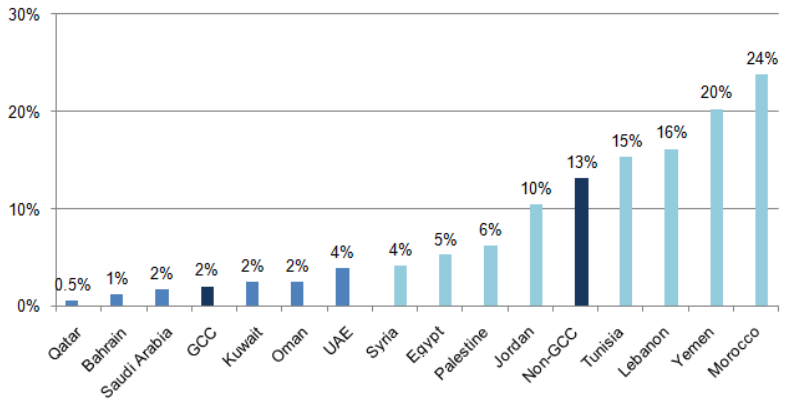
SMEs are the mainstay of most economies including Egypt's. However, they have limited access to external finance. This constrains their contribution to employment, growth and social inclusion Within an adequate regulatory and institutional framework, Islamic financial products can make a significant contribution to easing SMEs' access to finance. However, there is a need to deal with basic challenges that limit the menu of Islamic financial products to SMEs and their ability to contribute to Egypt's economic and social success.[44]

On average SMEs contribute 67% and 45% to formal manufacturing employment, in high income and developing countries respectively. Their contribution to GDP amounts to 49% and 29% in high income and developing countries respectively.[45] In Egypt, SMEs are estimated to be in the order of 6.4 mn with about 6% of them formal. [46]

In spite of their significant role in Egypt's and MENA's economies, SMEs' access to financing from banks remains limited. In Egypt, their share in total lending does not exceed 5% (Figure 7).[47]

[43] AfDB (2011)
[44] These challenges include clear and transparent regulation, adequate risk management practices, availability of reliable market information, competent Islamic finance professionals and other broad institutional infrastructure
[45] CGAP (2010)
[46] See McKinsey-IFC (2011)
[47] The Non GCC average includes Iraqi banks whose share is not separately reported. From Rocha et al. (2011)

Figure 7 MENA: Share of Loans to SMEs in Total Lending



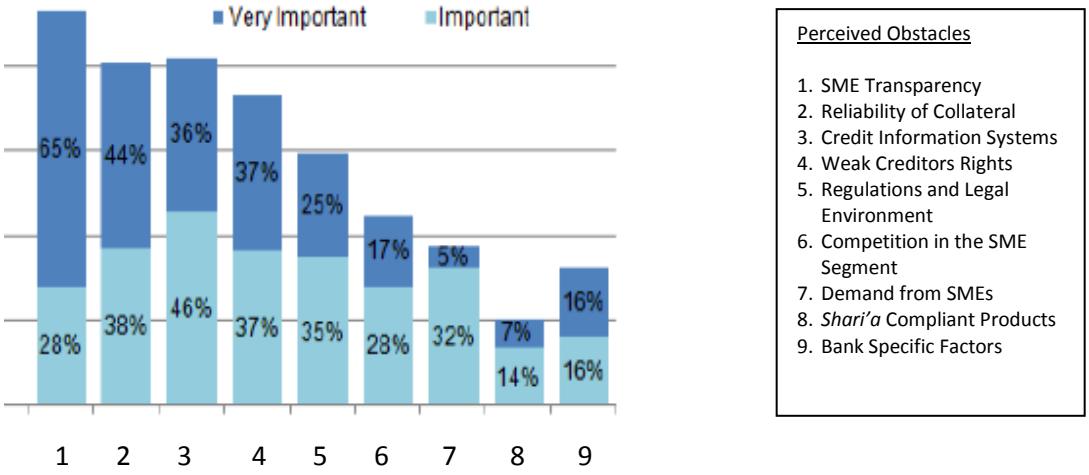
Source Rocha et al. (2011)

Various reasons underlie SMEs limited access to finance. Of course SMEs expected returns will be a major driver of bankers' lending to them. But bankers perceive SMEs as riskier than established corporations and find significant obstacles in extending lending to them (Figure 8). In particular, SMEs' transparency and collateral reliability are considered major obstacles. Apparently, bankers do not perceive *Shari'a* compliance as an important obstacle to lending to SMEs. However, this reported perception is a response to a direct question on the issue. Bankers' sense of a poor SMEs' demand for lending may reflect the absence of *Shari'a* compliant offerings and SME's reluctance to seek conventional funding.

Currently, in non GCC MENA, only a limited number of banks offer or plan to offer *Shari'a* compliant products to SMEs (Figure 9). However, an expanded menu of well structured Islamic finance offerings can contribute to enlarge acceptable financial resources to SMEs reluctance to seek conventional finance. It can also mitigate risks of lending to SMEs bankers perceive. In particular, the reliability of collateral may be less of an issue in Islamic financing, as the financier retains ownership title to the asset or commodity financed until it is fully repaid. Furthermore, Islamic finance could expand leasing facilities that are offered by only 26% non-GCC MENA banks to SMEs.[48]

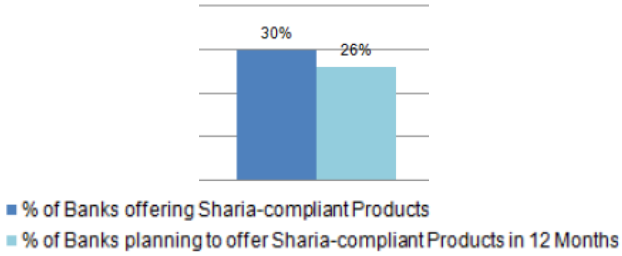
[48] Rocha et al. (2011)

Figure 8 Bankers' Perceptions of Obstacles to Lending to SMEs
Percent of Bankers' Responses – Non GCC MENA



Source: Rocha et al. (2011)

Figure 9 Supply of *Shari'a* Compliant Products – Non GCC MENA



Source: Rocha et al. (2011)

V. Regulatory Challenges and Blueprint for Development

Financial services are essentially an information based industry where public trust is critical. Accordingly, these services are highly regulated and subject to supervision by public authorities.[49] Adequate regulation promotes prudent conduct without stifling entrepreneurial initiative. It is critical to the stability and vibrancy of financial intermediation. Similarly, sound and vibrant Islamic finance requires

[49] The recent crisis following 2007 brought to the forefront these issues and highlighted their international dimension leading to a renewed emphasis on international financial standards and codes as well as subjecting financial organizations to stress testing.

also an adequate regulatory framework and effective supervision. They can instill public confidence in the industry and encourage innovation.

So far, the international response to the regulation of Islamic finance has been along one of two tracks.[50] The first stems from the view that Islamic finance is financial intermediation. It adds to the menu of financial services and can be regulated like any financial innovation is dealt with. Accordingly, the laws, regulations and supervision arrangements applying to financial intermediation should extend to Islamic finance. Adjustments and additions may be necessary as they would be in the normal course of other financial innovations.[51] Heretofore, the position adopted by the Egyptian banking regulator appears to have been in line with this view. However, there are currently efforts to develop an appropriate legal and regulatory framework to govern Islamic finance activity.[52]

Another view is that Islamic financial intermediation is intrinsically different from conventional finance. Accordingly, it would be difficult to extend to Islamic finance a conventional finance framework; Islamic finance requires specific laws, regulations and supervision arrangements to allow Islamic banks to operate. The incoming Egyptian authorities appear to be adopting this view.[53]

Thus, policy makers face the choice of either extending conventional regulation to Islamic finance or designing separate regulation for the industry. The first option raises conceptual challenges while the second runs the risk of containing the industry in a niche status. Alternative organizational arrangements could help the industry flourish and play an effective economic role without forcing it into the straightjacket of conventional regulation or circumscribing it to a niche activity.

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[50] It is interesting to note Mr. Bernanke's, US Federal Reserve Chairman, view: "I will argue that central banks and other regulators should resist the temptation to devise ad hoc rules for each new type of financial instrument or institution. Rather, we should strive to develop common, principles-based policy responses that can be applied consistently across the financial sector to meet clearly defined objectives". See Bernanke (2007)

[51] According to the Central Bank of Nigeria: "Islamic banking as one of the models of non-interest banking, serves the same purpose of providing financial services as do conventional financial institutions save that it operates in accordance with principles and rules of Islamic commercial jurisprudence that generally recognizes profit and loss sharing and the prohibition of interest, as a model".

[52] Already in 2010 the Egyptian Financial supervisory authority (EFSA) had announced the preparation of the first draft of sukuk regulations to be implemented by the first quarter of 2011 (IFIS 2011). However the events of early 2011 derailed that schedule. The parliament elected in 2011 prepared also legislation to establish a framework governing Islamic finance activity. It was however not discussed (IFIS 2012)

[53] See IFIS, June 12, 2012 - *Egypt Islamists draft code to boost Islamic banks*: "Ahmed al-Najjar, a member of the Freedom and Justice Party's economic committee, told Reuters that the proposals envisaged a new Islamic banking section being added to the law, which now has no specific regulations covering Islamic banks. Draft amendments to the law have been presented to parliament but no date has been set to discuss them, he said".

The following considers first the challenge of conceptual inconsistencies between *Shari'a* compliance and conventional banking regulations. It then outlines a blueprint of an alternative organizational arrangement that can help overcome the challenges and facilitate the development of a vibrant Islamic finance industry. [54]

1. Inconsistencies between Conventional Regulation and Islamic Finance Principles

Islamic banking offers services provided by conventional both banking and non-banking financial intermediation services.[55] Accordingly it can be awkward to directly apply conventional banking regulation to Islamic banks as it would entail extending banking regulation to non banking financial intermediation. The following highlights the challenges to bridge the requirements of the principles of risk-sharing, materiality and no-*riba* with those of conventional banking regulation.

In principle, a revenue earning "deposit" in an Islamic financial institution should be consistent with *risk-sharing* and accordingly would not correspond to the prevailing definition of a deposit in a conventional bank where: i) the deposit should be retrievable by the depositor at its face value; ii) the depositor is a priority senior creditor of the financial institution in case of its liquidation.[56] The *materiality* principle requires Islamic banks to bundle the associated real and financial transactions, entailing that the bank may enter into partnership with its clients or own the assets that they seek to finance.[57] It would conflict with the prevailing prohibition for conventional commercial banks to enter into partnerships with clients or have ownership of real estate and common stock. The prohibition of earning or charging interest, or *no-riba* is a central tenet of Islamic finance.[58] The remuneration resulting from a placement should not be pre-set or linked to the value placed. It should rather be the result of the efforts made in the economical use of the resources and accordingly should not be set a priori. In a dual conventional and Islamic financial system, the prohibition to transact in interest bearing debt instruments constrains the

[54] The following focuses on Islamic banking regulation as a separate area from Islamic non banking finance activities, notably takaful and capital markets activities. Non banking Islamic finance can more easily fit within conventional frameworks with minor adjustments. Also this paper does not deal with issues related to systemic liquidity management that present significant challenges to the operation of Islamic financial institutions.

[55] For example, investment account deposits are akin to mutual funds certificates; restricted investment accounts are close to services offered by private banking to high net worth individuals.

[56] Bollen, Rhys (2006)

[57] For example the bank could not lend money to an individual (lending contract) who would use the money to purchase a house (house purchase contract). In principle the lender would need to hold some ownership in the house until it is fully paid.

[58] There are different types of r*iba*, generally understood as interest. The prohibition of *riba* has generally carried over to the prohibition of charging or receiving interest. A minority interpretation is that *Riba* refers to usury rates and not to "reasonable" rates charged. See Mahmoud El Gamal (2003). See also http://www.islamic-finance.com/item5_f.htm

ability of: i) Islamic deposit-taking institutions to compete in attracting deposits; ii) Islamic deposit taking institutions to manage liquidity placing their own excess resources or accessing resources when needed notably on conventional money markets, or iii) monetary authorities governing dual Islamic and conventional financial system, in particular central banks to conduct monetary policy injecting or withdrawing resources from the financial system.[59]

2. A Blueprint for Mainstreaming Islamic Finance

Islamic finance can develop and flourish if its practitioners, supporters and regulators accepted that the concept of conventional *banking* as conventionally understood, implemented and regulated is not consistent with all the services Islamic finance can offer in compliance with *Shari'a* principles. Islamic financial services can develop, grow in importance, and contribute to financial inclusion if the industry considered also adopting organizational arrangements other than those of conventional banking. Other arrangements can allow the industry to remain true to its foundational principles and flourish, leverage prevailing regulations and overcome the perception that it is a niche activity.

The following suggests an organizational framework for Islamic finance that would allow it to flourish with minimal constraints from existing regulations. It would require minor regulatory adaptations while avoiding the hurdles of seeking the adoption of new regulations or awkwardly extending ones ill suited for its development. In this framework, consistency with Islamic finance principles is essentially the responsibility of Islamic finance organizations. They would enshrine them in their business policies and codes of conduct. The proposed approach is based on a consideration of the services Islamic finance offers and observing the degree of their similarity with services found across conventional finance, especially beyond banking. It would still require further progress in developing an effective framework and performing instruments for systemic liquidity management and the conduct of monetary policy.

Currently Islamic banks offer depositors *Amana*, unrestricted and restricted investment accounts deposits, the latter two mostly based on *mudaraba* contracts. They do fund various activities mainly through *murabaha, ijara, musharaka, istisna'a* types of contracts. To offer their services, Islamic banks request banking licenses and face the challenges outlined previously.

[59] Davies, Brandon (2011).

The same type of financial intermediation could be organized within the framework of a financial Holding *Group* or by independent organizations focused on specific business lines. Each entity, independent or subsidiary of a Holding group would conduct intermediation activity according to Islamic finance principles.[60] Each entity would conduct one of the following businesses for example: i) "Amana banking"; ii) Private banking; iii) Leasing-Ijara; iv) Project financing, or v) Private equity. Other entities may be established or the Holding Group can develop new subsidiaries in line with its business plan. For example, a Holding Group may choose to set up an investment banking subsidiary or integrate the activity within the core of the management of the Holding. Investment banking can help structure and place funding instruments such as *sukuks* for some of the subsidiaries (project financing or leasing).

A Holding Group would seek the licensing of each subsidiary within its overall business strategy or separate entities seek licenses specific to the business line they want to develop. In a natural way, each entity's business would be consistent with existing regulations and the essence of Islamic finance. Internal policies would help achieve full compliance with Islamic finance principles. A *Shari'a* board can be at the level of the Holding Group and would perform the roles existing *Shari'a* Advisory Boards play. The regulatory challenges of launching new Islamic financial services would be much diminished.

The following briefly highlights the features of subsidiaries and how the framework of a Holding Group permits simultaneous compliance with prevailing regulation and Islamic finance principles.

Amana banking would take Amana deposits that would be guaranteed and non remunerated complying with banking regulations and Islamic finance. It would offer deposit, payments, transfer and similar services needed in the conduct of current transactions. It could finance short term trade transactions according to *murabaha* contracts. The services of the Amana bank would be clearly specified as well as their costs. If it is established as a cooperative or credit union with Amana depositors being member

[60]See also El Gamal, M. (2005): "I propose mutuality as a solution to the corporate governance and regulatory problems currently unresolved due to the peculiar investment account structure. I show that mutual banking would be closer to the religious tenets enshrined in the prohibition of riba, and thus would strengthen the brand-name of Islamic banking by re-focusing it on the nature of finance and its objectives, and away from formal-legalistic contract mechanics"

shareholders, they would share returns realized within each period.[61] It would in essence be a "narrow bank".

Private banking would offer retail financial advisory services and wealth management.[62] It would care for Unrestricted and Restricted Investment Account holders. It would identify and offer them investment opportunities in mutual funds and other *Shari'a* compliant investments. Investment account holders would own certificates in special vehicles or funds with the clear awareness that the certificates' value and returns are not guaranteed. Unlike in the current structure of Islamic banks, unrestricted investment account holders would be certificate holders in special investment vehicles with recognized rights. The Private banking subsidiary would not need a deposit taking commercial bank license. It would not be pressed to engage in smoothing of returns as it would be competing with similar service suppliers, such as mutual funds. Given that there would be clear disclosure of the risk and returns prospects, there would not be displacement commercial risk and no need for related capital requirement. Competition in attracting funds would be based on performance track record across all investment vehicles in the market.

The offered investment vehicles would be either proprietary of the Holding Group or stemming from an open architecture approach. Debt based funds or ones that invest in financial papers of entities dealing with sinful activities would be excluded from the menu of offered investments. This Private banking subsidiary can be licensed within the framework of prevailing regulation and operate in compliance with it. Its internal policies and recourse to a *Shari'a* advisory board would ensure its full compliance with Islamic finance.

The Holding Group would have a *Leasing-Ijara* subsidiary. It would also be regulated and licensed according to the rules in place for leasing companies. It would compete with other leasing companies in the market offering equipment for lease to business entities.[63] The Holding Group's investment banking services can support the Leasing-Ijara subsidiary in securing funding for its activities.

[61] These returns are not known ex ante and accordingly their distribution to members-shareholders-depositors would be compliant with the risk-sharing and no guaranteed returns principles.
[62] See for example Bank Sarasin (2012) for the example of a conventionally licensed entity conducting Islamic Wealth Management.
[63] Some *Shari'a* pronouncements may restrict the activity to operating leases.

A *Project Finance* Company can be part of the overall structure within the Holding Group. This subsidiary would be expected to have recourse to various types of contracts as required. One would expected it to rely to a large extent on *bai salam and istisna'a*.[64] Other Islamic financial products could be devised.

The Holding Group can have a *Private equity* management company subsidiary. Private equity fund management is intrinsically consistent with Islamic finance. It uses *mudaraba* contracts on the funding side, extends financing with *musharaka* contracts and complies with the materiality principle. It can naturally be established within the framework of existing regulation. It can be made fully consistent with Islamic finance when the established private equity fund's policy excludes funding of sinful activities. A management fee and a *mudarib's* profit share are earned by the management company. The *rabul mal* or Limited Partner gets his share of return. The *rabul mal* is like a restricted account holder that elects to invest in a particular private equity fund. Clear regulations and practices followed by private equity management ventures can easily be drawn upon.

A Holding Group framework is not essential as financial entrepreneurs could focus on particular lines of business. However, the Holding Group approach could help share common costs such as those related to *Shari'a* compliance. The issue is essential a purely business one.

VI. Conclusion: Mainstreaming Islamic Finance

Over the last thirty years, Islamic finance has experienced a tremendous expansion in the size of assets and their diversification, number of Islamic finance institutions, and geographic scope. Noteworthy is Islamic finance development in non OIC member countries such as the UK or the USA. In the USA the industry developed in response to two types of needs: i) local communities retail finance needs, notably for mortgages and ii) foreign investors' needs to invest in the US market in a *Shari'a* compliant way. Worldwide, Islamic financial assets exceed USD 1.2 trn and are growing.

An early mover in the modern development of Islamic finance, Egypt has lagged behind Malaysia, Bahrain and GCC countries since the seventies. The country's Islamic financial assets are estimated around 5% of the total financial system. It includes a number of Islamic mutual funds, besides banking.

[64] See Zarqa, M. A. (1997) for how istisna'a can be used for project financing.

Moreover the country has managed to mobilize some Islamic funds for large scale projects, mainly with the support of the IsDB. Egypt has remained largely outside of the *sukuks* market, though some corporate activity is taking place and there are intentions of issuing sovereign *sukuks*.

This limited development goes hand in hand with the financial systems overall development, However, it also reflects the country's authorities' heretofore circumspect attitude towards the sector as well as regulatory and institutional challenges of integrating Islamic finance within the overall financial system. This limited development of Islamic finance in the country has excluded many from access to financial services as they are reluctant to deal with conventional finance either to place their resources or secure funding for their ventures. As a result, Egypt missed opportunities of access to financial resources and increase social inclusion and social equity.

Today, with the country's incoming authorities, there is the opportunity to set up a legal, regulatory and institutional framework to enable Islamic finance entrepreneurs to respond to market demand and give access to financial services to those who do not wish to deal with conventional finance. However, an appropriate and effective legal, regulatory and institutional framework is essential. It can provide an enabling framework for the industry to grow beyond a niche activity or avoid an unwieldy development. Ultimately, Islamic finance will be market tested and develop if it responds to market demand and offers efficiently the services needed.

A specific legal, regulatory and institutional framework runs the risk of maintaining Islamic finance in a niche status separate from the mainstream of finance even if it can handle adequately the industry's specificity. A joint effort by *Shari'a* finance scholars and mainstream finance regulators can address that challenge. It needs to focus on the substance of the activities and transactions rather than on their formal structures to overcome the pitfalls of niche status or unwieldy development. An organizational structure of a finance holding group with subsidiaries dealing with the substance of Islamic finance can overcome the conundrum of squaring the principles of Islamic finance with the requirements for conducting banking activity.

Egypt could once more take a leading role in Islamic finance by setting up a legal, regulatory and institutional framework that does not twist *Shari'a* principles or conventional banking rules by forcing

the industry to operate in the conceptual set up of banks. Amana banking and mutual funds can play a core role in "deposit" taking while not departing from either *Shari'a* principles or conventional finance rules. Leasing, project finance, private equity and *sukuks* can be effective instruments for funding business activity, investments and sovereign needs while complying with *Shari'a*.

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Appendix I Selected Islamic Finance Terms

Amana Quick definition: trustworthiness, faithfulness and honesty.	*Amana* is also used to define a situation in which one party is keeping another person's property in trust. This is the way in which the term is most commonly applied, especially within the confines of Islamic commercial law. The term is also applied when referring to goods on consignment, custody or deposit taking.
Arbun Quick definition: down payment.	*Arbun* describes the deposit that the buyer makes to the seller at the same time as making the agreement to complete payment by a set date
Gharar Quick definition: uncertainty.	*Gharar* refers to something that is not completely set in stone within a contract. It is a fundamental disagreement between Islamic and conventional UK law and Islam does not recognize the need for related practices such as speculation, derivatives and short selling contracts
Islamic finance Quick definition: financial services specifically designed to adhere to Islamic law or *Shari'a*	Although these financial services are designed for Muslims, they are not exclusively available to Muslims. Non-Muslims can also provide and buy the services
Ijara Quick definition: Islamic leasing agreement	An *Ijara* enables the financier to seek profit through the leasing of assets (house, car etc) rather than by actually lending money. *Ijara wa iqtina* is an extension of the concept which is a hire purchase agreement
Maysir Quick definition: gambling	*Maysir* is forbidden in Islam and as such the concept fundamentally disagrees with standard financial practices such as speculation, insurance and derivative contracts
Mudaraba Quick definition: investment partnership	This is the financial partnership between the investor (*Rab ul Mal*) and another party (*Mudarib*). The contract will set out how profits will be shared, and losses are absorbed by the *rab ul mal*. The *mudarib* foregoes some of the expected income in case of losses
Mudarib Quick definition: investment manager or entrepreneur partaking in a *mudaraba*	It is the *mudarib*'s responsibility to ensure that the investor's money is taken care of and is profitable in its investments. In turn the *mudarib* gets a share of the profits. The role is very similar to a mutual fund manager or a private equity general partner
Murabaha Quick definition: purchase and resale	The capital provider purchases the required asset or product (for which a loan would otherwise have been taken out) from a third party. The asset is then resold at a higher price to the capital user. By paying this higher price by installments, the capital user effectively gets credit without paying interest. (Also see *tawaruq* the opposite of *murabaha*)
Musharaka Quick definition: profit and loss sharing	This is considered the purest form of Islamic financing, because profits and losses are shared in proportion to the investment made by each investor. Each partner within the *Musharaka* contributes capital and can make executive decisions however they are under no obligation to. It is basically a partnership which involves owning voting stock in a limited company
Riba Quick definition: interest	*Riba* is forbidden by the Quran and it forbids any return of money on money, whatever type of interest it may be
Shari'a Quick definition: Islamic law	*Shari'a* refers to the law set down in the Quran and performed by example by Prophet Mohamed (PBUH). Any product purporting to be *Shari'a* must adhere to Islamic law in all respects and to ensure this, a company will usually appoint a *Shari'a* board which will overlook the development and implementation of all *Shari'a* products to ensure they comply
Shari'a adviser Quick definition: person who advises on Islamic financial law	A *Shari'a* adviser is generally an Islamic legal scholar who has been classically trained and has the expertise and knowledge to ensure products comply with Shari'a. Some work individually to advise companies but most are employed as part of a Shari'a board to ensure full compliance
Shari'a compliant Quick definition: observing Islamic law.	The *Shari'a* board ensures that products are *Shari'a* compliant. Many financial products use the term "*Shari'a* compliant" as a prefix to signal that the product has followed the law to the letter
Sukuk Quick definition: a bond	In conventional terms they are not quite the same as a bond is asset backed and the term "*sukuk*" describes the proportionate beneficial ownership in the asset itself.
Takaful Quick definition: Islamic insurance	Because the concept of insurance relates to uncertainty, which could then be related to interest and gambling, *Takaful* takes a different approach. The arrangement can be summed up as a charitable collection of funds based on the idea of mutual assistance
Tawaruq Quick definition: the Islamic way of obtaining cash	Liquidity instrument to mobilize cash. It involves buying something on deferred credit and selling the item on to get cash. As a result, cash has been obtained without taking out a loan and paying interest.

Source: Adapted from Canadian-Money-Advisor http://www.canadian-money-advisor.ca/archives/2006/05/islamic+finance+terms+glossary.html

Appendix II **Size of Islamic Finance**

In USD bn

Country	2007	2008	2009	2010
Iran	235	293	369	406
S.Arabia	92	128	161	177
Malaysia	67	87	109	120
UAE	49	84	106	116
Kuwait	63	68	85	94
Bahrain	37	46	58	64
Qatar	21	28	35	38
UK	18	19	24	27
Turkey	16	18	22	25
Bangladesh	6	8	9	10
Sudan	5	7	9	10
Egypt	6	6	8	9
Pakistan	6	5	6	7
Jordan	3	5	6	6
Syria	1	4	5	5
Iraq	---	4	5	5
Indonesia	3	3	4	5
Brunei	3	3	4	4
Other countries	7	7	9	10
Total	**639**	**822**	**1,036**	**1,139**

Source: Dar, H. and Azami Talha Ahmed, editors (2011)

Appendix III **Largest GCC Islamic Banks**

(USD mns)

Rank	Bank	Country	Year	Assets	Profits	Deposits	Loans	Equity
1	Al-Rajhi Bank	Saudi Arabia	2010	49,286	1,805	38,155	32,020	8,085
			2009	45,525	1,804	32,761	29,909	7,664
2	Kuwait Finance House	Kuwait	2010	44,800	379	27,259	na	4,598
			2009	40,237	424	25,036	na	4,281
3	Dubai Islamic Bank	UAE	2010	24,539	262	17,272	15,564	2,607
			2009	22,952	330	17,479	13,591	2,443
4	Abu Dhabi Islamic Bank	UAE	2010	20,499	279	15,386	13,500	2,205
			2009	17,452	21	13,123	11,293	1,399
5	Al-Baraka Banking Group	Bahrain	2010	15,879	193	2,906	1,538	1,818
			2009	13,166	167	2,607	1	1,736
6	Qatar Islamic Bank	Qatar	2010	14,204	366	8,291	9,721	2,500
			2009	10,761	362	5,579	7,481	2,467
7	Masraf al-Rayan	Qatar	2010	9,503	488	354	6,867	1,953
			2009	6,610	361	403	4,864	1,633
8	Emirates Islamic Bank	UAE	2010	8,916	450	6,595	3,982	797
			2009	6,885	413	5,287	4,548	782
9	Bank al-Jazira	Saudi Arabia	2010	8,804	8	5,904	4,987	na
			2009	7,993	7	5,581	4,134	na
10	Alinma Bank	Saudi Arabia	2010	7,111	4	2,217	4,158	na
			2009	4,614	161	400	300	na
11	Ithmaar Bank	Bahrain	2010	6,743	-139	4,657	5,123	654
			2009	6,105	-251	4,185	4,478	711
12	Bank al-Bilad	Saudi Arabia	2010	5,631	25	4,515	3,277	na
			2009	4,643	-66	3,658	2,936	na
13	Qatar International Islamic Bank	Qatar	2010	4,981	243	777	2,514	1,046
			2009	4,252	214	672	2,485	1,041
14	Boubyan Bank	Kuwait	2010	4,802	22	3,434	3,007	876
			2009	3,518	-190	2,583	2,102	325
15	Sharjah Islamic Bank	UAE	2010	4,538	72	2,826	2,628	1,184
			2009	4,349	71	2,685	2,728	1,161
16	Kuwait International Bank	Kuwait	2010	4,163	na	3,448	3,740	715
			2009	4,160	66	3,452	na	631
17	Kuwait Finance House Bahrain	Bahrain	2010	3,838	24	1,849	1,698	470
			2009	3,641	16	1,949	1,747	470
18	Arcapita	Bahrain	2010	3,457	-559	na	na	na
			2009	4,372	-88	na	na	na
19	Bahrain Islamic Bank	Bahrain	2010	2,482	-105	1,966	1,703	265
			2009	2,419	-51	1,804	1,589	373
20	Al-Salam Bank	Bahrain	2010	2,273	19	1,687	1,450	536
			2009	2,082	37	1,524	1,496	533

Source: IFIS -- September 19 2011

Appendix IV Islamic Finance in the US

In the US, one can identify four major developments for Islamic finance: i) regulatory opinions on the consistency of Islamic finance products with existing regulations, ii) introduction of Islamic retail finance, especially for home mortgages, iii) establishment of Islamic mutual funds and introduction of Islamic indices, particularly the Dow Jones Islamic and iv) emergence of whole sale finance focusing on foreign investors wanting to invest in the US in compliance with *Shari'a* structures.

A major breakthrough in the introduction of Islamic finance to the US market occurred with the United Bank of Kuwait's request for an opinion on the permissibility to offer *ijara*-based mortgages and securitize the products in 1997. Later, UBK requested an opinion on the permissibility of *murabaha* home, inventory, equipment and construction financing, in 1999. In both cases, the Office of Controller of Currency (OCC) provided the opinion of admissibility of the transactions based on the substance of their economic outcome rather than on their formal structure, guided by precedents from the courts. The approach taken by the US regulator is noteworthy. It does not seek to establish a separate regulatory framework to accommodate *Shari'a* rules applying to Islamic finance. It rather seeks to check whether Islamic finance products are admissible within existing regulations and their potential interpretations. The resulting principle and practice is that most Islamic finance activities can develop with the framework of the existing regulatory framework. The aspect that appears difficult to accommodate is to square the notions of conventional and Islamic deposits. The former has a guaranteed face value whereas the latter cannot if it generates returns.[65]

[65]See Yasaar Media (2009) The OCC was able to declare permissible: "impermissible forms under a literal interpretation of the banking laws so long as they create the economic outcome of permissible types of financing. This broad ability to interpret non-traditional financing methods makes US regulations quite flexible in accommodating Islamic financial products, but only in so far as they are "functionally interchangeable" with permissible products". See section V and VI below for a discussion of these issues and an approach to deal with them.

Box A.IV.1 Noteworthy Islamic Finance Retail Activities in the USA

Financial Institution	Location	Activity	Highlights
American Finance House-LARIBA	Early 1980 – Pasadena, California	Islamic Home, small business finance	Approval to receive financing from the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) in 2001
Guidance Financial (now called Guidance Residential)	2002 -- Washington, DC and the Maryland and Virginia	Islamic home finance using a diminishing *musharaka*	Agreement with Freddie Mac to finance $200 mn in home finance purchases; rose to more than $1 billion by the middle of 2007
Devon Bank	2003 -- Chicago	Small community bank offering Islamic mortgages following a demand from the local community	Sells its Islamic mortgages to Freddie Mac, since 2005.
University Islamic Financial Corporation	Ann Arbor, Michigan	Home finance and a deposit product that pays returns based on the return on the company's home finance products	Only wholly *Shari'a* compliant Islamic banking subsidiary in the USA
African Development Center in	Minneapolis- St. Paul, Minnesota	Provides business and entrepreneurial training and *Shari'a* compliant financing for American Muslim immigrants from Africa, primarily Somalia – *murabaha* product with financing from Freddie Mac and Fannie Mae	Has a nonprofit mortgage origination firm ADC Financial Services; financing from Freddie Mac and Fannie Mae; expanded program working with the Minnesota Housing Finance Agency.

Source: Adapted from Yasaar Media (2009)

Non bank financial institutions have dominated the Islamic finance market in the USA. Offers of Islamic mortgages (Box AIV.1) and *Shari'a* compliant mutual funds developed in response to local community needs. A major development in the Islamic mortgage business was Freddie-Mac's approval to finance mortgages originated by the American Finance House (LARIBA) in 2001. This approval, later replicated with other Islamic finance mortgage companies, gave the industry the means to significantly expand. A group of Muslims started an investment pool in 1984. When the demand grew beyond a size the pool could accommodate, its members called on a professional fund manager to help them set up a mutual fund, the Amana Income Fund. Later the Amana group and other managers launched other funds.[66] The industry received a significant push with the introduction of the Dow Jones Islamic index. It permitted the introduction of systematic screening as well as benchmarking facilitating transparency. Other indices followed. Besides retail markets institutions catering for the needs of the local community, a number of financial institutions developed their activities in the USA focusing on funds seeking to be invested in the

[66] Yasaar Media (2009) reports : "the Iman Fund, known as the Dow Jones Islamic Fund until 2008, and the Azzad Ethical Income and Ethical Mid Cap Funds were launched in mid-2000"

country but being *Shari'a* compliant. Naturally, these institutions were non-bank financial intermediaries and mostly private equity or broader capital management companies, two types of activities that are intrinsically more in line with *Shari'a* principles (Box A.IV.2).[67]

Box A.IV.2 Wholesale Islamic Finance in the USA

Financial Institution	Establishment Location	Activity
Arcapita	Since 1998 with the Arcapita name since 2005, based in Atlanta, Georgia	private equity, asset purchase and venture capital; United States is the destination for *Shari'a* compliant investments
Gulf Investment House (GIH) with Gulf Finance House (GFH) through Innovest Capital and TransOcean Capital	Since 2003, based in Cleveland, Ohio, and in Boston, Massachusetts	Private equity and real estate funds
Codexa Capital through Calyx Financial		Operates for offshore *Shari'a* compliant investments; between 2002 and 2008, Calyx Financial refocused its activities on structuring offshore products to connect businesses needing financing with investors looking for *Shari'a* compliant investment opportunities
Unicorn Investment Bank, through UIB Capital	Since 2004, based in Chicago, Illinois	Private equity firm
Anchor Finance Group	Since 2005, based in New York,	Business finance, product arranging and consumer financing, e.g. providing financing for investment properties owned by expatriate South Asians living in the United States in their home countries
Zayan Finance	Since 2007, based in New York, with offices nationwide	Commercial real estate investments, ranging from $500,000 to $2.5 mn

Source: Adapted from Yasaar Media (2009)

[67] There are also *Shari'a* compliant boutique investment companies that operate internationally from a US base such as The DateStone group, financial advisory and alternative asset management firm, www.thedatestonegroup.com

Appendix V. Compliance with *Shari'a* Rules and Corporate Governance

It is essential that Islamic finance's stakeholders have confidence that the business complies with the code of conduct the industry pledges to follow. A well established confidence can enhance financial performance, mitigate financial risks and encourage financial inclusion hence social equity. It is important that all Islamic financial institutions develop within a governance framework that promotes stakeholders' confidence that pledges of *Shari'a* compliance are being fulfilled. From an implementation perspective, a pledge to comply with *Shari'a* principles is similar to a pledge to abide by a code of corporate governance. Significant efforts have been made at the level of specific Islamic finance organizations, associations, regulators as well as international bodies. AAIOFI, the IFSB and others have set up principles of sound corporate governance for Islamic financial institutions.[68]

A widely adopted approach is to have independent bodies certify such compliance. Generally, each Islamic Finance Institution has in-house religious advisers, collectively known as the *Shari'a* Supervisory Board (*SSB*), as part of its governance structure. The ability of the *SSB* or *Shari'a* advisers to fulfill the mandate may be constrained by the volume of activity, their access to monitoring systems, the complexity of financial transactions or the extent of their independence. These factors may have been at play during distress episodes of Islamic financial institutions.

The functioning of a *SSB* raises five main CG issues: independence, confidentiality, competence, consistency and disclosure.[69] The first concerns the *independence* of the *SSB* from management. Generally, members of an *SSB* are appointed by shareholders of the institution, represented by the board of directors to whom they report. As such, they are employed by the IFI, and their remuneration is proposed by management and approved by the board. *SSB* members' dual relationship with the IFI, as providers of remunerated services and as assessors of the nature of operations, could create a conflict of interest. The issue of *confidentiality* arises from the practice of *Shari'a* scholars often sitting on the *SSB*s of several IFIs, thereby gaining access to proprietary information of possibly competing institutions. The third issue is *competence*. In performing their function, *Shari'a* scholars are expected to be familiar with Islamic law and to have financial expertise. In practice, very few scholars are well-versed in both

[68] See IFSB (2006), IFSB (2007), Grais (2009) and Grais and Pellegrini (2006)
[69] See Grais and Pelligrini (2006)

disciplines, though significant training efforts are helping deal with the issue.[70] The fourth issue is the *consistency* of judgment across IFIs, over time, or across jurisdictions within the same institution. Such consistency would help promote customers' confidence in the industry and the enforceability of contracts. Conflicting opinions on the admissibility of specific financial instruments or transactions can hurt business confidence and market efficiency. Finally, *disclosure* of all information relating to *Shari'a* advisory functions would strengthen the credibility that the offered services are compliant. Furthermore, disclosure promotes market discipline.

A *SSB* within an IFI has the advantage of being close to the market. A competent and independent *SSB*, empowered to approve new *Shari'a* conforming instruments, would facilitate innovation within the firm. In issuing its *fatwas*, the *SSB* could be guided by standardized contracts and practices that could be harmonized by an international standard setting, self-regulatory professionals' association. Such an approach could ensure consistency of interpretation and enhance the enforceability of contracts before civil courts. Review of transactions would mainly be entrusted to internal review units, which, in collaboration with external auditors, would be responsible for issuing an annual opinion on the *Shari'a* compliance of the transactions. This process would be sustained by reputable agents like rating agencies, stock markets, financial media and researchers that would channel signals to market players.[71]

[70] The situation is improving. Also a younger generation is gradually taking a larger role.
[71] See Grais (2009) for a proposal of a Systemic *Shari'a* framework.

Appendix VI News Report on Introduction of Islamic finance in Egypt

News reports on current debates on the development of Islamic finance in Egypt are directly presented in the following. They provide a sense of the issues being discussed. The news reports are mostly from the IFIS information service and Reuters.

A. Egypt Islamists draft code to boost Islamic banks

Monday, 11 June 2012

By REUTERS CAIRO

The political party of Egypt's Muslim Brotherhood, which has the biggest bloc in parliament, is proposing changes to the banking law with the goal of boosting the market share of Islamic banks to 35 percent in five years from 5 percent now, a party member said.

Ahmed al-Najjar, a member of the Freedom and Justice Party's economic committee, told Reuters that the proposals envisaged a new Islamic banking section being added to the law, which now has no specific regulations covering Islamic banks.

Draft amendments to the law have been presented to parliament but no date has been set to discuss them, he said.

Bankers say last year's revolt which toppled President Hosni Mubarak, whose regime neglected or discouraged Islamic finance for ideological reasons, has cleared the way for growth of Islamic finance in the Arab world's most populous nation.

They say the business needs a regulatory framework before it can grow but that the nation of 82 mn people, who are overwhelmingly Muslim, offers an attractive market. Islamic finance obeys religious principles such as bans on the payment of interest and pure monetary speculation.

According to a copy of the proposals obtained by Reuters, each Islamic bank would be required "to form an independent sharia (Islamic law) authority" with no less than three sharia experts who were registered with the central bank. Each expert would be allowed to serve with a maximum of two banks in Egypt. These sharia boards would supervise the banks' activities.

Islamic banks would be requested to create sharia-compliant instruments and a money market for surplus cash, according to the draft amendments.

One article states that Islamic banks must "insure customer deposits according to takaful Islamic insurance while not violating Islamic sharia rules".

The proposals also outline steps which conventional banks would need to take in order to open Islamic banking windows, keeping those accounts separate from their conventional accounts.

More than two decades ago, Egypt was a pioneer in Islamic finance, before development was slowed by a scandal over money management firms that touted Islamic investments at returns above prevailing interest rates.

Egypt now has 14 Islamic banking licenses. Operators include three full-fledged Islamic banks, such as Faisal Islamic Bank of Egypt, and several with Islamic windows, including National Bank of Egypt and Ahli United Bank, part of Bahrain's Ahli United Bank group, experts say.

The roughly 200 branches and 120 billion Egyptian pounds ($19.9 billion) of assets in Egypt's Islamic banking industry are dwarfed by Egypt's conventional banks. Total assets of the entire banking sector are about 1.3 trillion pounds, the latest central bank data show.

By comparison, Islamic banks account for over a quarter of assets in the Gulf's commercial banking market, according to an estimate by consultants Ernst & Young.

B. Egyptian Parliament Prepares Islamic Banking Regulation

Wednesday June 13, 2012 10:52:00 AM, IINA

Cairo: Egypt's parliament is drafting amendments to the country's central bank law, including the creation of an interbank market for Islamic banks. This was announced by Mohamed Gouda, a member of the ruling Freedom and Justice Party's (FJP) economic committee.

The regulations will aim at increasing the market share of Islamic banks to 35 percent in five years, compared to four percent now, the Cairo-based AlMal newspaper cited Gouda as saying. The law under discussion also stipulates raising the minimum capital for banks to 2 billion Egyptian pounds ($331 mn) from 500 mn pounds and limiting the governor to two four- year terms in office, according to the report.

FJP, the political party of the Muslim Brotherhood, which has the biggest bloc in Parliament, has proposed changes to the banking law with the goal of boosting the market share of Islamic banks to 35 percent in five years from 5 percent now, another party member said. Ahmed Al-Najjar told Reuters that the proposals envisaged a new Islamic banking section being added to the law, which now has no specific regulations covering Islamic banks. Draft amendments to the law have been presented to Parliament but no date has been set to discuss them, he said.

Bankers say last year's revolt which toppled President Hosni Mubarak, whose regime neglected or discouraged Islamic finance for ideological reasons, has cleared the way for growth of Islamic finance in the Arab world's most populous nation. They say the business needs a regulatory framework before it can grow but that the nation of 82 mn people, who are overwhelmingly Muslim, offers an attractive market. Islamic finance obeys religious principles such as bans on the payment of interest and pure monetary speculation.

http://www.ummid.com/news/2012/June/13.06.2012/egyptian_const_on_islamic_fin.htm

C. Egypt Brotherhood drafts sukuk law amid deficit

From IFIS
Publication: Tegara Net - Business News - EN
Provider: Tegara Net
May 2, 2012

Egypt's Muslim Brotherhood party is working on draft legislation to allow for the sale of Islamic bonds to help address a budget deficit and dwindling reserves.

"There's a big budget deficit and the government is borrowing through treasury bills and bonds with high yields," Ashraf Badreldin, a lawmaker with the Muslim Brotherhood's Freedom and Justice Party, said by phone from Cairo on April 30. "The goal is to enable the government to issue sukuk to finance infrastructure and other projects." The target is to complete the draft law by July, he said.

The North African country under toppled President Hosni Mubarak banned political parties based on religion and didn't develop Islamic debt markets. Egypt, which is paying near-record yields on local-currency debt after last year's uprising, may follow sovereigns in the six-member Gulf Cooperation Council in selling Shariah-compliant bonds, which pay returns to comply with the religion's ban on interest.

The Freedom and Justice Party makes up the largest bloc in parliament and is seeking to form a coalition government to replace the military-appointed interim cabinet. Presidential elections are scheduled to start this month. Economic growth in the nation of about 80 mn people slowed to 0.4 per cent in the final quarter of 2011 from 5.6 per cent a year earlier and the budget deficit is likely to exceed 9 per cent for a second fiscal year, government forecasts show.

Egypt sold the targeted 3 billion Egyptian pounds ($496 mn) of three- and seven-year treasury bonds on April 30 at average yields of 16.16 per cent and 16.91 per cent, respectively, according to data posted on the Finance Ministry website. That compares with the 16.12 per cent and 16.88 per cent the government paid at the last sales of similar-maturity securities.

"If the Freedom and Justice is part of the new government, then we envision issuing short-term sukuk to finance commerce," Mabid Ali Al-Jarhi, a party economic adviser, said by phone from Cairo April 30. "We will have a law for sukuk so that banks, companies, the central bank and the Finance Ministry can get financing through sukuk."

Still, foreign investors have shunned Egyptian securities and four credit rating cuts by Moody's Investors Service effectively shut the country out of global markets. Foreigners reduced their holdings of treasury bills in the 12 months to the end of January by 93 per cent to 3.8Bn pounds, according to central bank data.

The cost of insuring Egypt's debt against default rose 50 basis points in April to 610 basis points, the biggest monthly increase since December, according to data provider CMA, which is owned by CME Group Inc. and compiles prices quoted by dealers in the privately negotiated market. The credit risk was 608 basis points on May 1, the highest in the Middle East, and compares with 355 for Dubai and 360 for Bahrain.

The yield on Egypt's non-Islamic 5.75 per cent debt due April 2020 is up 173 basis points, or 1.73 percentage points, at 6.92 per cent today from the beginning of January 2011, before the uprising, according to Bloomberg prices. It had reached as much as 8.79 per cent this January. That compares with an average yield on sukuk in the GCC of 3.83 per cent on April 30, near the lowest since September, the HSBC/Nasdaq Dubai GCC US Dollar Sukuk Index shows. The yield tumbled 47 basis points in the first four months of 2012 as supply for the debt trails demand.

"Shariah-compliant institutions and funds are struggling to find paper to investment in and there's definitely a shortage of high-yielding securities," Jarmo Kotilaine, chief economist at National Commercial Bank, Saudi Arabia's biggest bank by assets, said by phone yesterday from Jeddah. "The appeal of Egyptian sovereign paper is that they offer attractive yields. If you believe the country will pay it back, then it's really a no brainer." Egypt is likely to lower borrowing costs with sukuk, he said.

Of the $18bn of debt sold this year in the Middle East and North Africa, $9.7bn was Islamic, data compiled by Bloomberg show.

Dubai, Ras Al Khaimah and Bahrain are the only three Arab sovereigns to sell sukuk. The yield on Dubai's 6.396 per cent sukuk due November 2014 declined 177 basis points so far this year to a record 3.81 per cent today, narrowing the gap between the debt and Malaysia's 3.928 per cent sukuk maturing June 2015 to 190 basis points. Malaysia is the world's biggest market for Islamic bonds.

Egypt's foreign reserves have tumbled almost 60 per cent since the start of the uprising last year and the government is in negotiations with the International Monetary Fund for a $3.2bn loan. Treasury-bill yields rose at auctions of six, nine- and one-year notes over the past week. The yield on the three-month notes was at 13.94 per cent after reaching a record 14.35 per cent in December.

"There's deterioration in foreign reserves and there's a need to import basic goods so we're thinking of having short- term, foreign currency sukuk to finance imports," Al-Jarhi said. "We hope to finance a big portion of the state's needs through sukuk and Islamic financing so that the budget deficit can be reduced."

Source: Alrroya

D. Political divisions slow Islamic finance in Egypt

From IFIS
Publication: Gulf Times
Provider: Gulf Publishing & Printing Co.
May 7, 2012

The headquarters of the National Bank of Egypt in Cairo. Egypt currently has 14 Islamic banking licences. Several banks such as National Bank of Egypt and Ahli United Bank, part of Bahrain's Ahli United Bank group, use Islamic windows for Shariah deals

Reuters/Cairo/Dubai

AlexBank, one of Egypt's biggest commercial banks, says it expects to launch Islamic financial services next April. But the country's political divisions mean the regulatory environment in which the bank will operate is not clear. Last year's ouster of president Hosni Mubarak, whose regime neglected or discouraged Islamic finance, has cleared the way for rapid growth of Islamic finance in Egypt, bankers believe.

But growth will require a regulatory framework, and a year after Mubarak left, basic decisions about regulation have not yet been made — and may not be made for many more months, as Egypt's transition to democracy distracts the government and political parties bicker over what form of Islamic jurisprudence the country should adopt. The country of over 80mn people is potentially an attractive market for Islamic finance, which is based on Shariah principles such as a ban on interest payments. Over two decades ago Egypt was a pioneer in developing the industry, before a scandal erupted over money management firms that publicized Islamic investments at returns above prevailing interest rates.

Egypt currently has 14 Islamic banking licenses. Operators include three full-fledged Islamic banks, such as Faisal Islamic Bank of Egypt, and several which use Islamic windows, including National Bank of Egypt and Ahli United Bank, part of Bahrain's Ahli United Bank group, according to Mohamed El-Beltagy, head of the Egyptian Society for Islamic Finance. The industry's roughly 200 branches and 120bn Egyptian pounds ($19.9bn) of assets are dwarfed by Egypt's conventional banking industry; total assets of the entire banking sector are about 1.3tn pounds, the latest central bank data show. By comparison, Islamic banks account for over a quarter of assets in the Gulf's commercial banking market, according to an estimate by consultants Ernst & Young. Some Islamic mutual funds were launched last year, by Al Watany Bank of Egypt, Naeem Financial and Banque du Caire, but only eight of 72 mutual fund products available in the market are Islamic.

AlexBank, majority owned by Italy's Intesa Sanpaolo, intends to use ten of its 200 branches to offer Islamic consumer banking products across the country, said Bassel Rahmy, head of retail banking. United Bank, majority owned by the central bank, has announced its intention to convert to Islamic operations

by the end of 2012. Meanwhile the Egyptian government has been considering the possibility of raising about $2bn by issuing its first sukuk, or Islamic bond, according to Sheikh Hussein Hamid Hassan, a prominent Dubai-based Islamic scholar who is familiar with its planning. A sovereign issue could ultimately encourage sukuk sales by private Egyptian companies. But expansion of the industry will need a legal framework to attract investors and limit risks to the banking financial system, and here progress is slow.

AlexBank's Rahmy told Reuters that commercial bankers had been discussing the subject with the central bank governor, who had indicated regulations would be prepared this year. The Egyptian Financial Supervisory Authority (EFSA) has said it is drafting rules to facilitate corporate sukuk issues. But there have been no clear public statements on the direction of policy. Senior EFSA officials did not appear at an Islamic finance seminar held in Cairo last month by Amanie, a global advisory firm in the industry. Although political parties have submitted proposals for regulations, economic officials from the parties decline to discuss them openly.

An industry source told Reuters that proposals on regulation were split between a moderate, more laissez-faire view of the industry espoused by the EFSA, and more restrictive views promoted by Islamist parties. For example the EFSA differs with the Muslim Brotherhood, which won the most seats in January's parliamentary elections, and the Salafi Al-Nour Party, which came second, on how sukuk should be structured, the source said.

The source declined to elaborate on the disagreement, but it may be related to differences of opinion among Islamic scholars and bankers globally on the merits of asset-based products, which use real assets such as land as references for their value, versus asset-backed products, which actually give investors ownership in the assets. Many scholars view asset-backed products as closer to Islamic principles, but land transfer fees and other issues can make them more complex and expensive to arrange.

The Brotherhood is generally more moderate than the Al-Nour Party, so it might be more willing to compromise on regulatory principles. On the other hand, if it is forced into cooperating with Al-Nour in the new parliament, it might give the hardline party more say over Islamic finance in exchange for concessions in other areas of economic policy. Policy issues are unlikely to be resolved until after a presidential election which starts in May, the climax of the shift to democracy. Afterwards, the distribution of power in the government should start to become clear, and agencies such as the EFSA may eventually be shaken up.

But even after the election, it may take months for Islamic finance to be addressed comprehensively. A major task for political parties is writing a new constitution, but the assembly charged with doing that has been suspended after liberals pulled out. One key issue which regulators will need to clarify is whether banks can get involved in Islamic finance through in-house windows or whether they must establish separate subsidiaries. The decision will affect banks' accounting treatment of their

operations.Islamic windows, used by global institutions such as Standard Chartered and HSBC, let conventional banks offer products without setting up expensive standalone operations. The banks would use controls to segregate conventional and Islamic funds. By contrast, countries such as Qatar require the complete separation of Islamic from conventional banking operations. Qatar has been an important financial supporter of Egypt, giving it a $500mn grant last year, so it is possible that the Qatari model could carry some weight.

Another unresolved issue is the authority of the boards of Shariah scholars which rule on the religious permissibility of banks' activities and products. Globally, some regulators establish a country-level board, while others leave it to each bank to set up its own board. Malaysia has a hybrid model; each bank develops products with the advice of its internal board but must then seek approval from the national board before marketing the products.Egypt "will require substantive Shariah board regulation, particularly for consumer-level offerings in banking, capital markets and takaful (Islamic insurance)," said Hdeel Abdelhady, a US-based legal consultant.

"The Malaysian approach to Shariah boards might be most suitable for the demographic make-up and temperament of the country," he added. However, Mohamed Daud Bakar, chairman of Malaysia's national Shariah board, said he believed the Indonesian model of regulation, which is lighter-touch than Malaysia's and does not involve so much intervention by central authorities, was more suitable for Egypt in the initial stage. "Malaysia is at a more advanced stage," he said. The government will also have to decide how much of a role it wants to play in guiding expansion of the industry. If it launches a regular programme of issuing sovereign sukuk, that could provide the pricing benchmarks needed to encourage development of a thriving market in corporate sukuk.

If the government does not promote sukuk actively, leaving growth of the industry in the hands of the private sector, development may initially focus on the launch of more Islamic funds, said another industry source familiar with the debate.