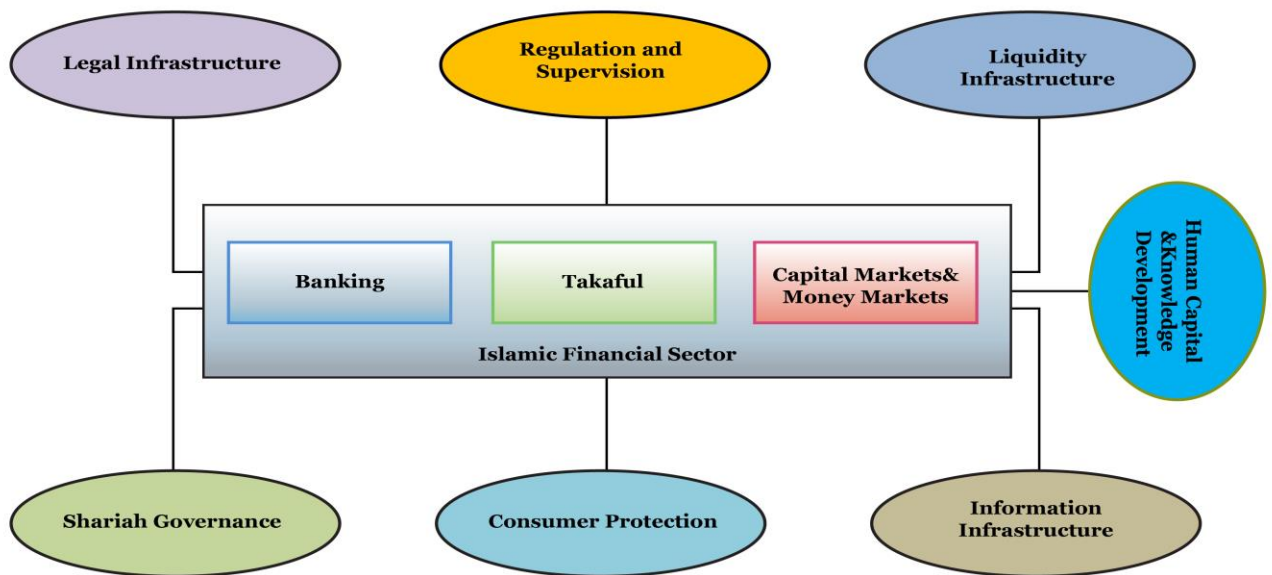




COMCEC

**Standing Committee
for Economic and Commercial Cooperation
of the Organization of Islamic Cooperation (COMCEC)**

**National and Global Islamic Financial Architecture:
Problems and Possible Solutions for the OIC Member Countries**



**COMCEC COORDINATION OFFICE
October 2016**



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**COMCEC COORDINATION OFFICE
October 2016**

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List of Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ACP	Authority of Consumer Protection (Oman)
ADCCAC	Abu Dhabi Commercial Conciliation and Arbitration Centre
ALFI	Association of the Luxembourg Fund Industry
AUM	Assets under management
BaFin	German federal financial services regulator
BCBS	Basel Committee on Banking Supervision
BCEAO	Central Bank of West African States
BI	Bank Indonesia (Central Bank of Indonesia)
BIS	Bank of International Settlement; Islamic Bank of Senegal
BNM	Bank Negara Malaysia (Central Bank of Malaysia)
BUS	Full fledge Islamic banks (Indonesia)
CBN	Central Bank of Nigeria
CBOS	Central Bank of Sudan
CFIs	Conventional financial institutions
CIBAFI	General Council of Islamic Banks and Financial Institutions
CIMA	Inter-African Conference of Insurance Markets (Senegal)
CIPA	Certified Islamic Professional Accountant
CIS	Collective Investment Schemes
CISI	Chartered Institute for Securities and Investment
CMA	Capital Market Authority
CRA	Credit Rating Agency
CREMPF	<i>Conseil Regional de L'Epargne Publique et Des Marches Financiers</i> (Financial markets regulators (Senegal))
CRSD	Committee for the Resolution of Securities Disputes (Saudi Arabia)
CSAA	Certified Shari'a Adviser and Auditor
CSSF	Commission de Surveillance du Secteur Financier (Luxembourg financial services supervisor)
DFID	Department for International Development (UK)
DFSA	Dubai Financial Services Authority
DIAC	Dubai International Arbitration Centre
DIFC	Dubai International Financial Centre
ECB	European Central Bank
ECOWAS	Economic Community of West African States
EGP	Egyptian Pounds
ETF	Exchange Traded Funds
EU	European Union
FI	Financial Institution
FSAP	Financial Sector Assessment Program
FWU	German insurance firm
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GIFDC	Global Islamic Finance Development Center
G20	Group of Twenty

HKMA	Hong Kong Monetary Authority
HQLA	High Quality Liquid Assets
IADI	International Association of Deposit Insurers
IAEI	Indonesian Islamic Economics Experts
IAH	Investment Account Holders
IAI	Indonesian Accounting Association
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IBFC	International Business and Financial Centre (Malaysia)
IBIs	Islamic banking institutions
ICD	International Corporation for the Development of the Private Sector
IDB	Islamic Development Bank
IFA	International Financial Architecture
IFC	International Finance Corporation
IFIs	Islamic financial institutions (IFIs)
IFRS	International Financial Reporting Standards
IFSA	Islamic financial Services Act (Malaysia)
IFSB	Islamic Financial Services Board
IICRCA	International Islamic Center for Reconciliation and Commercial Arbitration
IIFM	International Islamic Financial Markets
IILM	International Islamic Liquidity Management Corporation
IIMM	Islamic Interbank Money Market
IIRA	Islamic International Rating Agency
INCEIF	International Centre for Education in Islamic Finance (Malaysia)
IMF	International Monetary Fund
INFE	International Network on Financial Education (OECD)
IOSCO	International Organization of Securities Commission
IRR	Investment Risk Reserves
IRTI	Islamic Research and Training Institute
IsFA	Islamic Fiqh Academy
IsMF	Islamic Monetary Fund
ISRA	International <i>Shariah</i> Research Academy for Islamic Finance (Malaysia)
KLRCA	Kuala Lumpur Regional Centre for Arbitration
LCR	Liquidity Coverage Ratio
LMC	Liquidity Management Center
LOLR	Lender of the Last Resort
MAS	Monetary Authority of Singapore
MASB	Malaysian Accounting Standards Board
MCs	Member countries
MENA	Middle East & North Africa
MFRS	Malaysian Financial Reporting Standards
NAICOM	National Insurance Commission (Nigeria)
NAV	Net Asset Value
NBFCs	Non-banking finance companies
NBFIs	Nonbank Financial Institutions
NDIC	Nigerian Deposit Insurance Corporation (Nigeria)
NSA	National <i>Shariah</i> Authority
NSFR	Net Stable Funding Ratio
OECD	Organisation for Economic Co-operation and Development

OIC	Organisation of Islamic Cooperation
OJK	Financial Service Authority (Indonesia)
PER	Profit Equalizing Reserves
PKR	Pakistani Rupees
PSAK	Financial Accounting Standard (Indonesia)
PSIA	Profit Sharing Investment Accounts
PTC	Participation Term Certificate (Pakistan)
REIT	Real Estate Investment Trust
RM	Malaysian Ringgit
ROSC	Reports on Standards and Codes
ROW	Rest of the World
SAC	<i>Shariah</i> Advisory Council (Malaysia)
SAMA	Saudi Arabian Monetary Agency
SB	<i>Shariah</i> Board
SBIF	Stability Board for Islamic Finance
SBP	State Bank of Pakistan (Central Bank)
SCM	Securities Commission Malaysia
SEC	Securities and Exchange Commission
SGF	<i>Shariah</i> Governance Framework
SHSB	Shari'ah High Supervisory Board (Sudan)
SLR	Statutory Liquidity Requirements
SMEs	Small and Medium Enterprises
SQR	<i>Shariah</i> Quality Rating
SSB	<i>Shariah</i> Supervisory Board
UAE	United Arab Emirates
UCITS	Undertakings for the collective investment in transferable securities
UNCITRAL	United Nations Commission on International Trade Law
UK	United Kingdom
VAT	Value added tax
WAEMU	West African Economic and Monetary Union

Executive Summary

The financial sector performs various functions that facilitates the efficient functioning of the economy and promotes economic growth. For the financial sector to contribute to growth and mitigate risks, however, the industry itself has to be resilient and be able to reduce its own vulnerabilities. Recognizing this, various international organizations such as the International Monetary Fund, World Bank, Basel Committee for Banking Supervision, etc. are working on developing various institutional standards, tools and policies necessary for the creation of a sound framework for the development of the financial sector. Other than prudent financial system supervision and regulation, the WB and IMF (2005) identify legal infrastructure, systemic liquidity infrastructure, governance and information infrastructure, payments and securities settlement systems, creditors' rights, the provision of incentives for strong risk management, credit reporting systems, etc. as being among the key architectural institutions needed to promote the development and stability of the financial sector.

The Islamic financial sector has expanded globally in its short history with total global assets valued at USD 1.88 trillion in 2015 (IFSB 2016). Growing at a compound annual growth rate of 17% between 2009 and 2013 (IFSB 2015), the industry is expected to become systematically important in many jurisdictions. The global role of Islamic finance has grown in many global financial centers such as the UK, Luxembourg, Singapore, Hong Kong, Japan, etc. Given the above, a sound financial architecture will be crucial for its future development as a robust and resilient industry. While most of the elements of financial architecture that promote development in conventional finance also apply to Islamic finance, there are certain specific issues that arise in the latter due to unique features arising from Shariah compliance. However, being a relatively new industry in most countries, the infrastructure institutions supporting the industry remain weak and are continuing to evolve.

Given the vital roles that architectural institutions play in promoting the growth and stability of the financial sector, this study aims to identify the unique features of the financial architecture governing Islamic finance, assess their statuses in selected OIC member countries (MCs), and provide policy recommendations for improvement at both the domestic and international levels. The study examines the status of seven categories of the Islamic financial architecture (legal infrastructure; regulation and supervision framework; Shariah governance framework; liquidity infrastructure; information infrastructure and transparency; consumer protection architecture; and human capital and knowledge development framework) for 12 OIC MCs. It also explores the status of Islamic finance in five countries with global financial centers (the UK, Germany, Luxemburg Singapore, Hong Kong). After presenting the overall sizes of the financial sectors, the approaches taken towards Islamic finance in these countries are discussed.

The study first examines the legal environment and the features of the financial sector of OIC MCs. Most OIC MCs have adopted some variant of common law and civil law systems, with 16 countries having the former and 40 adopting the latter. The study shows that while the overall average size of the banking sector in OIC MCs is similar to the world average on the liabilities side, it is smaller for banking assets and the insurance sector. While the debt securities market is underdeveloped in OIC MCs compared to the world average, stock market capitalization is relatively higher. Information on the features of the financial sector shows that the average depth and access of the financial institutions and financial markets in OIC MCs is lower than the world average. However the average efficiency of both financial institutions and financial

markets in OIC MCs are higher than the world average. Though the financial institutions appear to be stable, the financial markets indicate lower levels of stability compared to the world average.

The experience of the development of Islamic finance in non-OIC countries with global financial centers varies across jurisdictions and sectors. Industries such as Islamic retail banking and takaful sectors catering to the needs of domestic clients are limited to countries that have significant Muslim minorities. These sectors have developed in the United Kingdom and Singapore with institutional support from governments. While Germany has a relatively large Muslim minority group, no takaful companies exist and Islamic retail banking has only just been initiated there recently. This is partly because the government and regulators have not shown strategic interest in the development of Islamic finance. The international market segment in the global financial sectors consists of retakaful, wholesale banking, and the provision of capital market products such as funds and sukuk. While reinsurance companies based in Singapore are offering retakaful services, German companies are offering these services from their overseas offices based in Muslim countries. The United Kingdom and Singapore have also taken initiatives to encourage the development of wholesale banking markets to cater to the needs of Muslims for wealth management. With the exception of Germany, the key focus of remaining global financial centers studied has been the capital markets segment. Governments in these countries have promoted the sector, sometimes by accommodating laws and regulations to attract globally mobile Islamic financial businesses.

The OIC MCs case-studies show that countries have different levels of development of Islamic financial architecture. On average, other than 'information infrastructure' and 'consumer protection infrastructure' which are 'underdeveloped', most of the architectural elements are in the 'developing' stage. At the international level, development of standards and guidelines by multilateral institutions can help promote sound architectural institutions. Countries with underdeveloped infrastructures can benefit by using the framework provided by international benchmarks to develop institutions that can support the Islamic financial industry. The key features of the financial architectural elements are highlighted below:

Legal Infrastructure: The results from the legal infrastructure for Islamic finance indicate that there is scope to strengthen legal institutions. Not only is there need to enact supporting Islamic financial laws and adjust tax laws, the bankruptcy framework and dispute resolution institutions also need to accommodate the Islamic financial sector. At the international level, the gaps in legal infrastructure in terms of laws related to Islamic finance will be easier to fill if there are model laws that the countries can refer to. However, currently there are no global initiatives that deal with legal matters. Initiatives from organization such as IDB can develop templates for Islamic financial laws and also come up with a framework for harmonizing national laws with Shariah principles governing Islamic finance for both civil law and common law countries.

Regulation and Supervision Framework: The regulatory authorities need to understand the nature of the risks arising in the Islamic financial industry to develop appropriate regulatory frameworks. This may require not only appropriate regulations for all Islamic financial sectors but also separate departments/units in regulatory bodies dealing with the Islamic financial sectors. Although the IFSB has published many regulatory standards and guidelines for the Islamic financial industry, the coverage for different sectors has not been even. As the Islamic financial industry is expected to grow in the future, there may be a need to strengthen the

institutional capacity of the IFSB. One way to do this is to have separate divisions within the IFSB dealing with issues related to Islamic banking, takaful and Islamic capital market segments.

Shariah Governance Framework: The regulators play a key role in setting up the Shariah governance regime by providing a framework for Shariah boards for financial institutions. A national Shariah board would be responsible for issuing Shariah standards/parameters and promoting the harmonization of practices by ensuring the Shariah compliance of the contracts used in the industry. Both AAOIFI and IFSB have published Shariah governance standards for Islamic financial institutions. However, there are no guidelines for national Shariah boards. Given that national Shariah boards can contribute to the harmonization of practice and the reduction of costs of Shariah governance in organizations and Shariah compliance risks within jurisdictions, there is a need to come up with a framework for it. Furthermore, the work on developing Shariah standards, parameters and templates for Islamic financial products by the AAOIFI, IsFA and IIFM need to continue to enhance cross-border and international transactions by reducing legal and Shariah compliance risks.

Liquidity Infrastructure: A robust liquidity infrastructure consists of appropriate instruments, efficient and liquid financial markets, and access to LOLR funds from central banks. There is not only a scarcity of Shariah compliant liquid instruments, but most jurisdictions also lack deep and efficient Islamic financial markets. While the central bank and regulatory authorities can help develop the infrastructure for financial markets, the liquidity instruments can be supplied by both public and private entities. Globally, the secondary markets for sukuk in most countries are shallow, making them illiquid. IFSB and IIFM can develop guidelines and templates to strengthen money markets, secondary markets for Islamic securities, and LOLR facilities for Islamic banks.

Information Infrastructure and Transparency: To properly reflect the transactions and operations of Islamic financial institutions, countries can opt for using either AAOIFI accounting standards or domestic accounting standards adapted by Islamic finance. Other than the credit ratings provided by conventional rating agencies for debt based transactions, other types of assessments such as Shariah compliance ratings and providing assessments for equity modes of financing are also needed for Islamic finance. Globally, there is significant progress being made towards developing accounting and auditing standards by AAOIFI. Furthermore, AAOIFI and IFSB have also published disclosure guidelines for the banking and takaful sectors. There is a need to develop detailed disclosure guidelines for Islamic capital markets and Shariah compliance of products and securities. Ratings agencies that can assess Shariah compliance and risks in equity based instruments can further strengthen the information infrastructure for the industry.

Consumer Protection Architecture: The study finds the architectural element of consumer protection to be the weakest for the Islamic financial sector in the countries that were examined. While instituting appropriate laws and regulations to protect consumers and deposit insurance have to be implemented by the government and regulators, improving financial literacy will require effort at different levels. Initiatives at the global level to develop consumer protection guidelines that cater to the specific features of the Islamic financial sector and also come up with a framework for financial literacy programs will help their implementation at the national level. While the former can be done by IFSB, the latter can be initiated by CIBAFI. To protect Islamic banking depositors during crises would also require

appropriate models for deposit insurance. IFSB can collaborate with IADI to initiate this project.

Human Capital and Knowledge Development Framework: Human capital and knowledge development appear to be the strongest element of the Islamic financial architecture. However, as the industry is expected to grow, there will be increasing demand for personnel with the appropriate knowledge and skills, particularly in countries where the industry is relatively new. In this regard, the public and private sector entities, along with academic institutions and universities, can contribute to providing training and building a knowledge base for the future growth of the industry. Various multilateral organizations such as IRTI, IDB and World Bank GIFDC are involved in research that can promote the development of the Islamic financial sector. There is also need to invest in research and provide training in different areas related to Islamic architectural institutions. One key gap that needs to be filled is creating knowledge related to infrastructure institutions and providing training to staff in public bodies that work in the industry. While IFSB organizes workshops to familiarize its published standards and guidelines, multilateral organizations such as IDB and WB can take initiatives to enhance such knowledge and skills to develop other elements of infrastructure institutions through their technical assistance programs.

The development of standards and guidelines by international multilateral institutions is one of the key instruments for developing sound architectural institutions. Specifically, countries with underdeveloped infrastructures can benefit by using the framework provided by international benchmarks to develop institutions that can support the Islamic financial industry. The study suggests strengthening the existing international infrastructure institutions and establishing some new ones. Developing legal documents and templates can help the development of the legal infrastructure for Islamic finance in OIC MCs. This initiative is similar to the *Law and Policy Reform Program* of the Asian Development Bank and can be best performed by IDB. While IFSB has developed many regulatory standards for the Islamic financial industry, the published standards and guidelines for different sectors have not been even. As the Islamic financial industry is expected to grow in the future, there may be a need to strengthen the institutional capacity of IFSB. One way to do this is have separate divisions within IFSB dealing with issues related to Islamic banking, takaful and Islamic capital market segments.

Both AAOIFI and IFSB have published Shariah governance standards for Islamic financial institutions. However, as there are no guidelines for national Shariah boards, there is a need to come up with a framework for it. Furthermore, the work on developing Shariah standards, parameters and templates for Islamic financial products by AAOIFI, IsFA and IIFM need to continue to enhance cross-border and international transactions by reducing legal and Shariah compliance risks. There is a need to develop detailed disclosure guidelines for all segments of Islamic finance and improve Shariah compliance of products and securities. Ratings agencies that can assess Shariah compliance and risks in equity based instruments would further strengthen the information infrastructure for the industry.

IFSB and IIFM can develop guidelines and templates to strengthen money markets, secondary markets for Islamic securities, and LOLR facilities for Islamic banks. Furthermore, there is a need to establish an Islamic Monetary Fund (IsMF) that can either provide Shariah compliant liquidity at the global level or coordinate arranging liquidity from other central banks by using swap arrangements.

As the Islamic financial industry is expected to grow in the future and become systematically important in some countries, the study suggests establishing a Stability Board for Islamic Finance (SBIF) to enhance the global stability and development of a sound Islamic financial sector. Among others, SBIF can come up with a framework for establishing an Islamic Financial Sector Assessment Program (IFSAP) and also the relevant Standards and Codes applicable to the Islamic financial sector, coordinate the implementation of existing standards from IFSB and AAOIFI, and contribute to filling the gaps in other architectural elements such as the legal and Shariah governance frameworks for the Islamic financial sector globally. As the body would engage key policy holders from different countries, the suggested organization, SBIF, can be initiated by either OIC under the realm of COMCEC or by D-8 countries.

1. Introduction

The financial sector performs various functions that facilitate the efficient functioning of the economy and promote economic growth. Levine (1997: 689) identifies the functions of a financial system as “the trading of risk, allocating capital, monitoring managers, mobilizing savings, and easing the trading of goods”.¹ For the financial sector to contribute to growth and mitigate risks, however, the industry itself has to be resilient and be able to reduce its own vulnerabilities. The global financial crisis (GFC) highlights the vulnerability of the financial sector and its detrimental impact on output and welfare with the monetary cost of the crisis estimated to be as high as USD 15 trillion (Yoon 2012).² Given the complexity and dynamism of modern financial products and markets, appropriate institutions are needed to reduce the risks and vulnerabilities that can potentially lead to harmful and costly economic downturns. This would require certain architectural institutions and policies that foster a stable and efficient financial sector that effectively promote economic development.

Financial transactions are legal constructs with contracts that usually have the realization of their outcomes in the future. The theoretical basis of the need for a sound institutional environment facilitating economic and financial development lies in New Institutional Economics which asserts that institutions such as laws, the executive, legislature, judiciary, etc. provide the formal rules that enforce property rights and promote economic activities (Williamson 2000). An institutional framework introduces first order economizing in the economy by providing supporting rules of the game that enables the production and exchange of goods and services in an orderly manner. For example, organization, financial institution, tax, and contract laws are relevant to the construction of financial transactions. Specifically, organizational law determines the types of organizations that can be formed and banking law specifies the legal requirements to establish and operate banks. Tax laws relevant to the financial sector are related to income (profit), transactions (capital gains and stamp duties) and goods and services (value-added tax). Contract law provides the principles and basis of conducting transactions. While ‘law and finance’ literature assert that legal institutions have an influence on financial development, the ‘political institutions and finance’ strand maintains that ‘political institutions’ that protect property rights are also important determinants of financial and economic development.³ Recognizing this, various international organizations such as International Monetary Fund, World Bank, Basel Committee for Banking Supervision, etc. are developing various institutional standards, tools, and policies necessary for a sound framework for the development of the financial sector.

The role of the financial sector in promoting development depends on both demand and supply side factors. On the supply side, the financial sector has to be inclusive and provide various financial services to all segments of the population including the poor. On the demand side, two broad types of markets can be identified: domestic and international. An issue on the demand side in Muslim countries relates to voluntary exclusion whereby a large segment of the

¹ Similarly, Merton and Bodie (1995) identify six functions of financial system as managing risks, transferring economic resources, dealing with incentive problems, pooling of resources, clearing and settling payments (to facilitate trade) and providing price information.

² Researchers from the Federal Reserve Bank of Dallas estimate the losses from GFC in the US to be in the range of USD 6 to USD 14 trillion. See Atkinson et. al. (2013).

³ For the former literature see La Porta et. al. (1997 &1998) and for the latter see Acemoglu and Johnson (2005)

population does not deal with the interest-based financial sector due to religious convictions.⁴ Inclusive financial systems in many OIC member countries (MCs), therefore, require providing Shariah compliant financial services so that all segments of the population can benefit from the financial system and contribute to the development process. Although Islamic finance predominantly serves the financial needs of Muslims who do not want to engage with conventional finance for religious reasons, it can also be an alternative source for ethical and social finance for much wider markets.

With USD 1.88 trillion worth of assets in 2015, the Islamic financial sector has expanded globally in its short history (IFSB 2016). While the conventional financial sector stalled after the global financial crisis, the Islamic financial industry grew at a compound annual growth rate of 17% between 2009 and 2013 (IFSB 2015). It is expected that by 2020, a significant part of the banking and finance in the Gulf and in some South-east Asian countries such as Malaysia and Indonesia will be Islamic. The global role of Islamic finance is also expected to expand as many global financial centers such as the UK, Luxembourg, Singapore, Hong Kong, Japan, etc. have taken initiatives to introduce Islamic finance.

With its growth, the Islamic financial sector is expected to become systematically important in many jurisdictions. A sound financial architecture will be crucial for its development as a robust and resilient industry. However, being a relatively new industry in most countries, the infrastructural institutions supporting the industry remain weak and are still evolving. This is reflected in a survey conducted by MEGA (2016: 50) which reveals that 38% of the respondents identify regulatory costs and 18% point out *Shariah* compliance costs as factors that limit the growth of Islamic banks. Meanwhile, 29% of the respondents identify regulatory issues and 17% identify the lack of liquid markets as being among the biggest external threats. Furthermore, the internal threats identified were a shortage of qualified personnel, identified by 28% of the respondents, and *Shariah* compliance issues, identified by 21% of the respondents (MEGA 2016: 51).

While most of the elements of financial architecture that bring about stability and promote development in conventional finance also apply to the Islamic financial sector, there are certain specific issues that arise in the latter due to some unique features arising from Shariah compliance. Compliance with *Shariah* introduces some unique risks in Islamic financial institutions and also restricts the use of certain risk-mitigating tools that are available to their conventional counterparts. Furthermore, Islamic finance operates in countries that have legal and regulatory systems that are not Islamic. Given the above, specific architectural institutions are needed for the future development of Islamic finance. This study attempts to identify these institutions, examines their statuses in selected countries, and suggests ways in which these can be developed.

The remainder of the chapter is organized as follows. The next section presents a brief overview of the evolution of the notion of financial architecture in conventional finance followed by a section that outlines the aim and scope of the study. The concluding section provides the outline of the key architectural institutions that will be examined in this study.

⁴ Karim et al (2008) find that an estimated 72 percent of the people living in Muslim countries do not use formal financial services and a large percentage of the population (ranging from 20 to more than 40 percent) would not avail conventional microfinance to avoid interest.

1.1. Financial Architecture: Concept and Background

The notion of a financial architecture was first discussed after the Asian financial crisis of the late 1990s. As the crisis revealed several weaknesses in the financial systems of afflicted countries, a group of Finance Ministers and Central Bank Governors met in Washington DC in 1998 to discuss ways in which financial systems could be strengthened nationally and globally to bring about stability and avoid the recurrence of such crises (BIS 1998). The need for sound structural, social and macroeconomic policies to bring about not only financial stability but also promote economic development and poverty eradication were underscored (World Bank 2005). The initiatives that would promote financial stability by preventing and managing crises were discussed under the framework of the development of International Financial Architecture (IFA). IFA would include arrangements and actions that would not only strengthen country level financial systems but also the global level institutions to ensure stability and facilitate financial integration (World Bank 2005).

There were two key components of the IFA initiative: crisis prevention and crisis mitigation and resolution. Policies to prevent crises included the 'development and implementation of international standards and good practice' on the one hand and 'deepening and broadening surveillance, and intensifying capacity building' on the other hand (World Bank 2005: 4). The World Bank and IMF used two key tools to accomplish these goals: first, the Financial Sector Assessment Program (FSAP) identified the strengths and weaknesses of the national level financial sectors, and, second, the Reports on Standards and Codes (ROSC) initiative strengthened the soundness and transparency of institutions, markets and policies related to the financial system. The ROSC assesses the compliance of national architectural institutions with international standards in 12 areas including corporate governance, accounting and auditing, insolvency and creditors' rights, regulation of banks, insurance and securities markets, payments and settlements systems, anti-money laundering and financing terrorism, and transparency of data, fiscal, monetary and financial policies (World Bank 2001 and 2005).

After the global financial crisis of 2007-2008, the FSAP program was reviewed and changes were introduced (IMF 2014). Changes included adding focus on systemic risks, improving analytical capabilities to assess vulnerabilities and resilience and improving the quality of the country level Financial Sector Stability Assessment (FSSA) reports. For developing and emerging economies, the FSAP would have two broad components, one assessing the financial stability and the other assessing the financial development. Indicators of financial stability include not only the soundness of banks and other financial institutions but also the quality of the supervision of banks, insurance and capital markets against international standards and the ability of policy makers and financial safety-nets to respond to negative shocks. Financial development indicators include the quality of the legal framework and the financial infrastructure in promoting the financial sector that serve all segments of the population (IMF 2015).

WB and IMF (2005:5) identify three pillars of the financial system architecture that can promote the stability and development of the financial sector. Whereas Pillar I relates to macro-prudential surveillance and financial stability analysis, Pillar II deals with sound financial system supervision and regulation. Pillar III involves financial system infrastructure that include legal infrastructure for finance; systemic liquidity infrastructure; and transparency, governance and information infrastructure. Some other financial infrastructure institutions include payments and securities settlement systems; creditors' rights; the

provision of incentives for strong risk management; and good governance, credit reporting systems, etc.

For Islamic finance, IFSB (2015a) identifies several preconditions that must be fulfilled for effective regulation and supervision that can ensure the stability of Islamic financial institutions. These include "sound and sustainable macroeconomic policies; well established framework for financial stability policy formulation; well-developed public infrastructure; a clear framework for crisis management, recovery and resolution; appropriate level of systemic protection (or public safety); and effective market discipline" (IFSB 2015a: 9). A well-developed public infrastructure would entail key architectural elements such as a system of business laws; well-defined internationally accepted accounting principles and rules; an efficient and independent judiciary; competent and experienced professionals; well-regulated payment systems; credit bureaus; and the availability of basic economic, financial and social data and information (IFSB 2015a: 10). In this study, 'financial architecture' and 'infrastructural institutions' are used interchangeably.

1.2. Aim, Objectives and Scope of the Study

Given the vital roles that architectural institutions play in promoting the growth and stability of the financial sector, the aim of this study is to identify the unique features of the financial architecture governing Islamic finance, assess their statuses in selected countries, and provide policy recommendations for their improvement at both the domestic and international levels. The specific objectives of the research are as follows:

1. Assess the status of development of key legal/regulatory institutions, level of overall financial development, and the status of Islamic finance in OIC MCs.
2. Provide an overview of the key financial architectural elements relevant to the Islamic financial sector.
3. Assess the statuses of the architectural institutions in 12 OIC MCs.
4. Appraise the statuses of the Islamic financial sector in five countries hosting international financial centers.
5. Identify the gaps and strengths of architectural institutions at the national and global levels based on the case-studies.
6. Provide policy recommendations to develop different Islamic financial institutions and identify the roles that different domestic and international stakeholders can play in the process.

In line with the traditional classifications of the financial sector used in literature (Crockett 2009: 18), the key financial sectors considered for the study are banking, insurance/takaful and capital markets. As indicated, the range of elements of a sound architecture for the development of a stable and resilient financial sector is wide. Some of the elements of financial architecture are neutral and apply to both Islamic and conventional finance. These include sound and sustainable macroeconomic policies, effective market discipline, well-regulated payment and clearing systems, etc. However, there are certain unique features in the Islamic

financial sector that may not be covered by the conventional architectural institutions and require specific attention. The elements of the Islamic financial architecture that need special attention and are discussed in this study can be classified into seven categories as identified below:

Legal Infrastructure: Existence of supporting Islamic finance laws, tax regimes impacting Islamic finance, dispute settlement/conflict resolution framework and institutions, and resolution of banks.

Regulation and Supervision Framework: Appropriate regulatory and supervisory frameworks for Islamic banks, *takaful* and Islamic capital markets including the presence of separate regulatory departments/units dealing with Islamic financial sectors. Rules related to the nature of the Islamic financial industry and the existence of Islamic windows/subsidiaries in conventional banks.

Shariah Governance Framework: Existence of regulatory standards for *Shariah* governance and whether Islamic financial institutions are required to use IFSB/AAOIFI *Shariah* governance guidelines of AAOIFI *Shariah* standards. Determine the role of central national *Shariah* board (if it exists) and its responsibilities and scope.

Liquidity Infrastructure: Status of liquidity management framework (markets and arrangements) and liquidity management instruments and products for Islamic financial institutions. Need for *Shariah* compliant LLOR facilities and instruments that Islamic banks can use.

Information Infrastructure and Transparency: Requirements to use either AAOIFI accounting/auditing standards or domestic standards adapted to Islamic finance. The legal and regulatory framework of the country related to transparency and disclosure for IFIs. Existence of organizations providing credit ratings for *sukuk* issuance and *Shariah* ratings of Islamic financial institutions.

Consumer Protection Architecture: Laws/regulations related to the protection of consumers of the financial sector in general and Islamic financial institutions in particular and institutional mechanisms/arrangements to address the unfair treatment of consumers. Deposit insurance scheme for depositors of Islamic banks in the country. Scheme for financial literacy in the country and if there are any specific schemes for Islamic financial consumers.

Human Capital & Knowledge Development Framework: Adequate personnel to cater to the needs of the Islamic financial sector at different levels (such as regulatory bodies, IFIs, law firms, etc.). Existence of public and private educational/academic institutions to enhance the knowledge and skill levels for the Islamic financial sector.

1.3. Methodology

1.3.1. Sample Countries

The study includes the case studies of 12 OIC countries. Different criteria are used for choosing countries as case studies. First, there is regional diversification to ensure that there are countries from three regions of the OIC (i.e., Africa, Arab and Asia). Secondly, as the financial

architecture will partly depend on the legal regimes, countries are chosen so that there is diversity in their legal systems. Legal regimes can be broadly classified as those that are based on Islamic law, common law and civil law. The third criterion is the size of the Islamic financial industry. Countries with larger Islamic financial sectors will provide an indication on the financial architecture under which the industry has evolved. Given the above criteria, the countries included as case studies for the study are shown in Table 1.1.

Note that all countries in the table, except Nigeria and Oman, fulfill the different criteria identified above. These two countries are added as Islamic finance has emerged there relatively recently. The reason for the inclusion of Nigeria where Islamic finance started in 2011 is to increase the number of countries from the African region to two. Oman is also added as a new entrant with good potential of growth due to its sound legal and regulatory infrastructure. Since the inception of the first Islamic bank in 2013 in the country, its share has already jumped to 4.4% of the total banking assets.

Global financial centers chosen for the study are based on their importance and size on the one hand and their potential to develop Islamic finance on the other hand. The countries examined are UK, Germany, Luxembourg, Hong Kong and Singapore. Note that instead of discussing the global financial centers as cities, the study examines countries where these centers are located. This is because, for example, while Islamic financial activities in the international financial center of Frankfurt is very small, Munich is nevertheless host to some large insurance companies that also deal with *retakaful*. By discussing the non-OIC global financial centers in terms of countries, the market segment in Munich can be added. Similarly, Islamic retail banking (AlRayyan Bank) in the UK is headquartered at Birmingham. Thus, expanding the scope of case studies to the country level will enable us to capture Islamic finance at a broader scale.

Table 1.1: List of Countries to be used as Case Studies

Country ^a	Region	Legal System Family ^e	Size of IF sector: % National Banking Assets	Size of IF sector: Global share of IF assets
1. Bangladesh	Asia	Common Law	17	1.34
2. Egypt	Arab	Civil Law	4 ^b	1.17
3. Indonesia	Asia	Civil Law	4.6 ^c	1.39
4. Malaysia	Asia	Common Law	21.9	9.56
5. Nigeria	Africa	Common Law	N.A.	N.A.
6. Oman	Arab	Civil Law	4.4 ^d	N.A.
7. Pakistan	Asia	Common Law	9.8	0.75
8. Saudi Arabia	Arab	Islamic law	51.3	18.57
9. Senegal	Africa	Civil Law	N.A.	N.A.
10. Sudan	Arab	Islamic Law	100	1.00
11. Turkey	Asia	Civil Law	5.7	3.2
12. UAE	Arab	Civil Law	17.4	7.36

a-All data for 2014H1 (source IFSB 2015) except otherwise indicated; b-Data for 2012 (source SESRIC 2012); c-Data for 2015 (Source Tampubolon 2015); d- TR, IRTI and CIBAFI (2015). e-World Bank (2004). Note that the countries are classified according to legal origins such as English, French, German, etc. While the English is considered common law, the continental European legal systems belong to civil law regimes. The World Bank does not include Islamic law as a category. This category is added for Saudi Arabia and Sudan as these countries have Islamic legal systems.

1.3.2. Data Collection and Analysis

Other than presenting quantitative data related to the size and status of the Islamic financial sector in different jurisdictions, the bulk of the discussion on Islamic financial architectural institutions will be qualitative in nature. The sources of data and information will include policy documents from international organizations and standard setting bodies, national level legal and regulatory documents and standards, and publications on financial architectural institutions. Data sources will include global databases such as World Bank's *Doing Business, Legal and Regulatory Database, Global Survey on Consumer Protection and Financial Literacy* and country specific documents such as *Financial Sector Assessment Reports*, laws, regulations and standards related to the financial sector. While most of the information/data will be collected from secondary sources, the country level materials from different sources are also used to communicate with the relevant personnel in their respective jurisdictions.

Both quantitative and qualitative methods are used to analyze the information/data for the study. While a descriptive analysis is carried out on quantitative data, the financial architecture elements are assessed by doing content and thematic analyses of various documents and literature and also the information gathered at the country level through interactions with relevant personnel in their respective countries. The research is descriptive and evaluative and attempts to arrange, summarize, and present data/information to enable a meaningful interpretation and produce material that can identify gaps in Islamic financial architectural institutions and come up with appropriate policy recommendations.

1.4. Overview of the Study

Other than the introductory chapter, the study has seven chapters. A brief overview of these chapters is given below.

Chapter 2: Financial Sector in OIC Member Countries and Islamic Finance: Global Status and Evaluation

The chapter starts by outlining the legal regulatory environment and presenting the size and characteristics of the financial sectors in OIC MCs. This is followed by a discussion of the foundational principles of Islamic finance and the features of the basic contracts used in Islamic finance. After presenting a brief historical overview of the development of Islamic finance and the supporting infrastructure institutions, the chapter ends by examining the global status of the Islamic financial industry.

Chapter 3: Islamic Financial Architecture: Key Components and Framework

While there are some common elements that apply to both the conventional and Islamic financial sectors, certain infrastructure institutions are unique to Islamic finance. The key issues of seven categories of the Islamic financial architecture (legal infrastructure; regulation and supervision framework; Shariah governance framework; liquidity infrastructure; information infrastructure and transparency; consumer protection architecture and; human capital and knowledge development framework) are discussed in the chapter.

Chapter 4: Islamic Finance Architecture: Case Studies of Selected OIC Member Countries

In line with the framework of the Islamic financial architecture presented in Chapter 3, aspects of the seven elements of financial architecture for Islamic finance of 12 OIC countries will be presented in this chapter. Noting that in some countries the elements of the different infrastructure categories do not exist, the country level reports are expected to identify the general (conventional) case and then discuss the Islamic alternative for each category, if it exists.

Chapter 5: Global Financial Centers and Islamic Finance

This chapter explores the status of Islamic finance in non-OIC global finance centers. Five countries with global financial centers used as case studies are the UK, Germany, Luxemburg Singapore and Hong Kong. After presenting the overall sizes of the financial sectors, the approaches taken towards Islamic finance in these countries are discussed. Depending on the size of the Muslim population and the strategic outlook towards Islamic finance, global centers have approached various sectors of Islamic finance differently.

Chapter 6: Issues Needed for Further Development: Institutional Perspective

Based on the country case studies, this chapter highlights the strengths and weaknesses in the financial architectural institutions of the Islamic financial industry. The issues are discussed in a comparative way under the headings of the seven institutional categories. After presenting the institutional statuses of each infrastructure institution for individual countries in a comparative way, the overall average statuses of these elements for the whole sample of countries are examined. The chapter ends by providing an overview of the international institutions in supporting different architectural institutions.

Chapter 7: Policy Recommendations

Based on the findings from case studies, this chapter puts forward policy recommendations at the national and international levels to strengthen the financial architecture for Islamic finance. Different stakeholders who will be responsible for strengthening different institutional elements at both the national and international levels are also identified.

Chapter 8: Summary of the Findings and Conclusion

The last chapter summarizes the key findings of the study at the national level, international level and global financial centers. In particular, the key gaps are highlighted and the roles of different stakeholder in filling these are identified. The chapter ends with concluding remarks with some suggestions for further research.

2. Financial Sector in OIC Member Countries & Islamic Finance: Global Status & Evaluation

This chapter provides an overview of the status of the financial sector of OIC MCs and the global standing of Islamic finance. The chapter is divided into three broad themes. The first theme covers the general features of the financial sector in OIC MCs vis-à-vis other countries of the world. In this part, the legal and regulatory framework that affect the financial sector is presented, followed by a section that presents the relative size of the banking insurance and capital market segments. Different features of the financial institutions and markets (depth, access, efficiency and stability) in OIC MCs relative to the countries in different income groups are also presented.

The second theme of the chapter provides background material on the Islamic financial industry. After presenting the basic principles and values of Islamic economics and finance, the structures of the basic contracts used in Islamic finance are discussed. This is followed by a brief historical overview of the development of Islamic financial institutions and the global infrastructure institutions for the Islamic financial industry.

The final theme of the chapter covers the global status of Islamic finance by presenting the size of the global Islamic financial institutions and financial markets across different geographical regions. Specifically, the global status of financial institutions (Islamic banking, takaful and nonbank financial institutions) and capital market products (Islamic funds under management and sukuk) are presented.

2.1. Legal/Regulatory Environment in OIC Member Countries: A Brief Overview

As modern finance is 'legally constructed' (Pistor 2013: 315), a well-developed legal framework is necessary for the efficient and effective functioning of financial markets and institutions. Stability and resilience of financial systems partly depend on the ability of the legal environment supporting contractual agreements used by markets and institutions to promote exchanges and decision making by economic units and prevent harmful practices such as fraud, collusion, corruption, etc. A sound legal infrastructure would include various laws that promote growth by mobilizing savings and converting it into productive capital (Moskow 2002).

Although the personal law in most Muslim countries is still Islamic, most Muslim countries have adopted some variant of western legal systems either due to colonization or imitation. In general, the legal systems can be broadly classified as common law and civil law systems. While common law is associated with English law, the legal systems of continental Europe constitute civil law. Thus, with the exception of a few countries, the commercial laws of most OIC MCs are either common law or civil law based. Specifically, countries that were ex-British colonies have adopted the English common law framework and ex-French colonies have adopted a civil law regime. Many countries in the Arab world have adopted variants of the Egyptian legal system which has a legal code based on the French and European civil law. Each legal family shapes the legal rules that affect the financial markets and their development (La Porta et.al. 1999). Table 2.1 shows the distribution of the legal regimes of OIC MCs in different

regions. The predominant legal regime in OIC MCs is civil law that is based on the legal systems of continental Europe in general and the French legal system in particular.

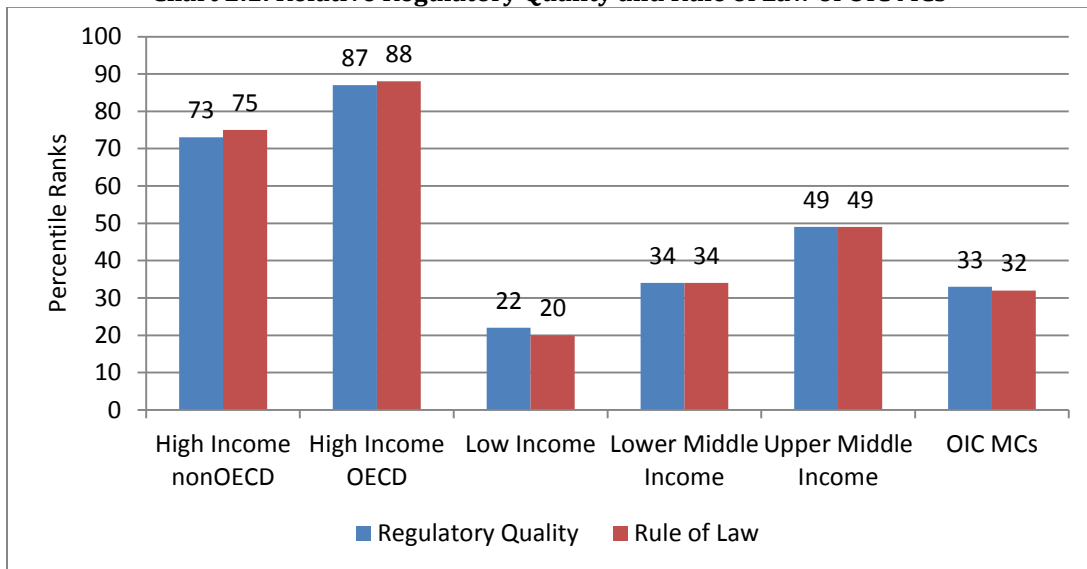
Table 2.1: Legal Regimes in OIC Member Countries

Regions	Common Law	Civil Law
Africa	3	14
Arab	6	15
Asia	7	11
Total	16	40

Source: La Porta et. al (1999) and World Bank (2004).

The relative status of the legal and regulatory environment in OIC MCs is assessed by using the Regulatory Quality and Rule of Law indices published by World Bank. While the former reflects ‘perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector’ the latter indicates ‘perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence’. The governance indicator estimates can take values ranging from -2.5 (weak) to 2.5 (strong) performances. The average estimated values for 56 OIC MCs were -0.58 for Regulatory Quality and -0.60 for Rule of Law.

Chart 2.1: Relative Regulatory Quality and Rule of Law of OIC MCs

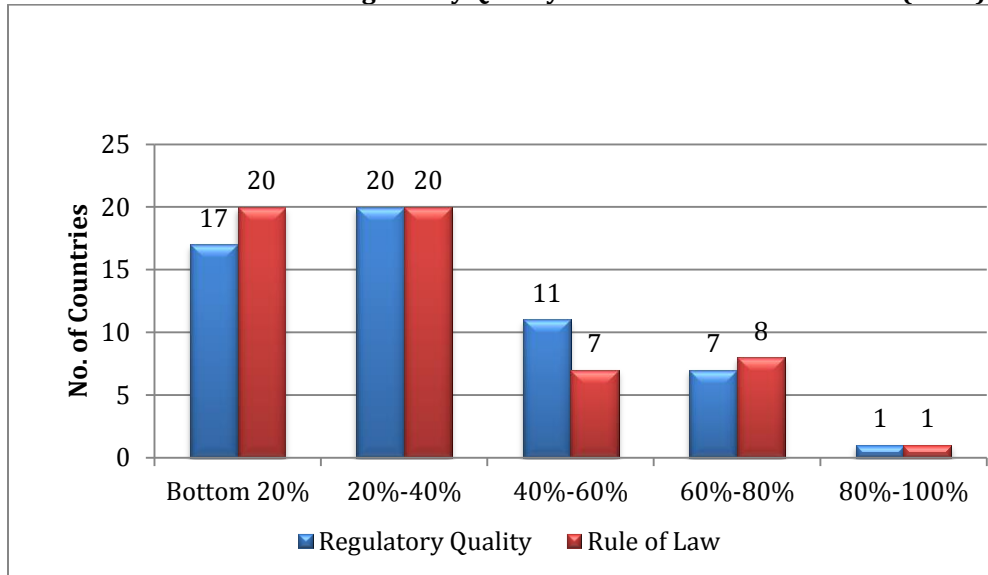


Source: Calculated from World Bank World Governance Indicators Database

Chart 2.1 shows the averages of relative percentile ranks (ranging from a lowest of 0 to a highest rank of 100) of countries in different income groups and OIC MCs for the two governance indicators. The average Regulatory Quality percentile rank of OIC MCs is 33 which is close to that of countries in the Lower Middle Income group. Similarly, Rule of Law average ranking is at the 32 percentile which is slightly lower than that of the Lower Middle Income group. Although the governance indicators are relatively better than that of Low Income countries, overall the results indicate a relatively poor regulatory quality and rule of law regimes when compare to other income groups.

Chart 2.2 shows the breakdown of the percentile rankings of OIC countries for governance indicators into different quintile groupings. While 17 countries have rankings falling in the bottom quintile (20 percentile) for Regulatory Quality, 20 countries fall in this category for Rule of Law. Similarly, 20 OIC MCs have percentile rankings that fall in the 20%-40% range for both indicators. A few OIC MCs have relatively better rankings for the governance indicators with one country being in the top 20 percentile for both indicators and 7 countries falling in the 60%-80% range for Regulatory Quality and 8 countries being in this range for Rule of Law.

Chart 2.2: Distribution of Regulatory Quality and Rule of Law in OIC MCs (2014)



Source: Calculated from World Bank World Governance Indicators Database

2.2. Financial Sector in OIC Member Countries: Size and Characteristics

The status of the financial sector in OIC MCs relative to countries in different income groupings and the world is presented under two broad categories. First, the overall development of the financial sector is examined by assessing the relative size of the banking, insurance and capital market sectors. Second, the status of the financial sector is analyzed in terms of four characteristics identified in the Global Financial Development Report by World Bank (2016). Specifically, the depth, access, efficiency and stability of financial institutions and financial markets of OIC member countries are compared relative to the averages of countries in different income groupings.

Most of the data used in this section is collected from the Global Financial Development database of the World Bank for the year 2013.⁵ The average figures for different variables for OIC member countries (MCs) are calculated as a mean of the values of countries for which the data is reported. As the information for all OIC MCs is not available for different variables, the

⁵ Most of the data for different variables are from 2013. When information for 2013 was absent, data from 2012 or 2011 were used. The data for 'Account at a formal financial institution (%age 15+)' is from 2011.

number of countries used to estimate the OIC MCs average is identified when discussing the results.

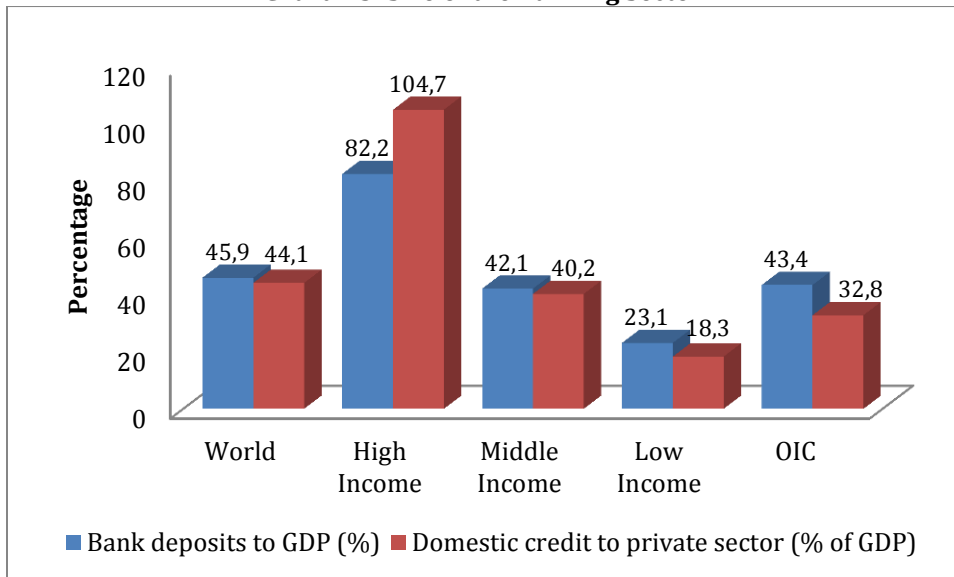
2.2.1. Relative Size of the Financial Sector

The size of the financial industry relative to the GDP is a good indicator of the sector's development. The relative size of the banking, insurance and capital markets of OIC member countries and the average for world, high, middle and low income groupings are presented below.

Banking Sector

Two variables used to assess the size of the banking sector are demand, time and savings deposits in deposit money banks as a share of GDP (bank deposits as % to GDP) and claims on the domestic real nonfinancial sector by deposit money banks as a share of GDP (domestic credit to private sector as a % of GDP). Chart 2.3 shows that the average percentage of bank deposits for 49 OIC MCs is 43.4% of GDP compared to 45.9% for the world. While the average for OIC MCs is lower than that of high income countries (82.2%), it is significantly higher than low income countries (23.1%) and is close to that of middle income countries. However, the average for credit given to the private sector for 48 OIC MCs is 32% which is lower than the averages for the world (44.1%), high income countries (104.7%), and middle income countries (40.2%). These numbers indicate that while the status on the liability side of the banking sector of OIC MCs is similar to the averages of the world and middle income countries, the average size on the banking assets financing the private sector is lower.

Chart 2.3: Size of the Banking Sector

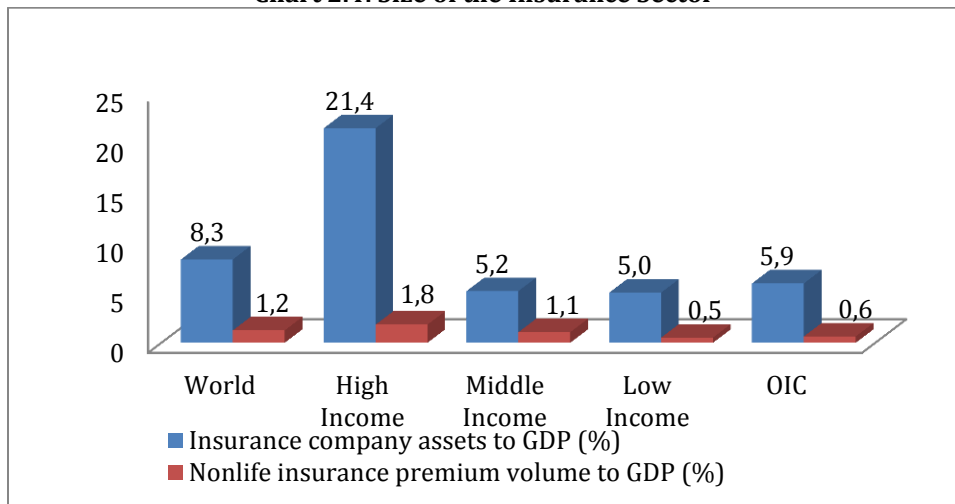


Source: Calculated from World Bank Global Financial Development database

Insurance Sector

The size of the insurance sector is measured by Insurance company assets as a percentage of GDP and nonlife insurance premium volumes as a percentage of GDP. Chart 2.4 shows that the insurance company assets for 13 OIC MCs (5.9% of GDP) is lower than the averages for the world (8.3%) and high income countries (21.4%), and it is similar to both middle income (5.2%) and low income countries (5%). The nonlife insurance premium for 44 OIC MCs (0.6% of GDP) is close to that of low income countries (0.5%) and is lower than the averages for the world (1.2%), high income (1.8%) and middle income countries (1.1%). Thus, it can be concluded that the insurance sector for OIC MCs is relatively smaller.

Chart 2.4: Size of the Insurance Sector

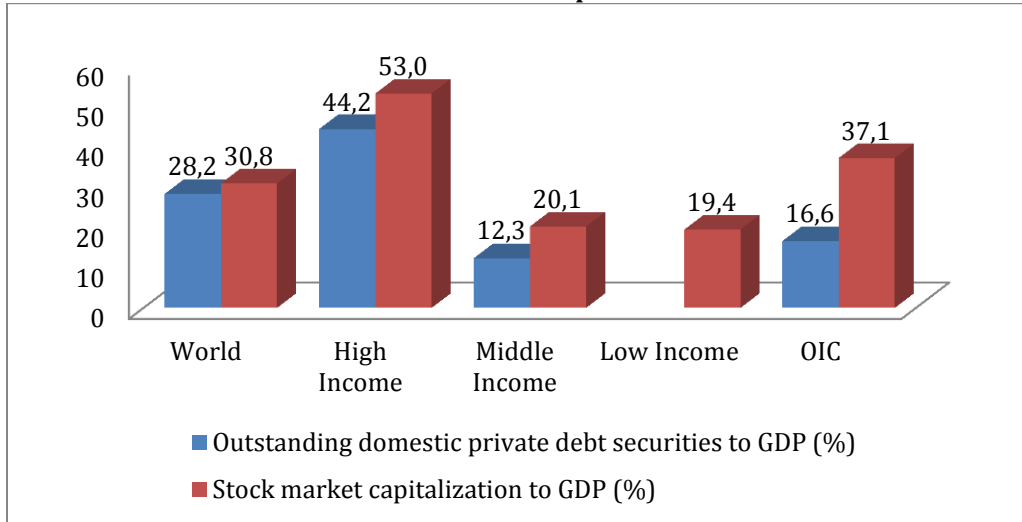


Source: Calculated from World Bank Global Financial Development database

Capital Markets

The size of the capital markets is measured by variables representing the size of the debt and equity markets. The former is measured by the Outstanding Domestic Private Debt Securities as a percentage of GDP and the later by Stock Market Capitalization as a percentage of GDP. Chart 2.5 shows that the domestic private debt for four OIC MCs is 16.6% of GDP compared to 28.2% for the world, 44.2% for high income countries, and 12.3% for middle income countries. Note that there is no information for this variable for low income countries. Furthermore, as only four countries are used to find the average for OIC MCs, it may not be representative. Some of the counties not included may not have a domestic private debt securities market and this information is not captured in the OIC MCs' average. The stock market capitalization as a percentage of GDP for 23 OIC MCs is 37.1%, which is the second highest after high income countries (53%). This figure shows that the average size of the stock markets in OIC MCs is relatively larger than those of the world (30.8%), middle income countries (20.1%), and low income countries (19.4%).

Chart 2.5: Size of the Capital Markets



Source: Calculated from World Bank Global Financial Development database

In summary, the results show that while the size of the banking sector of OIC MCs is close to that of the world average, the insurance sector is still relatively small. Similarly, in capital markets, the stock market in OIC MCs is relatively large, but the debt securities market is smaller than the world average.

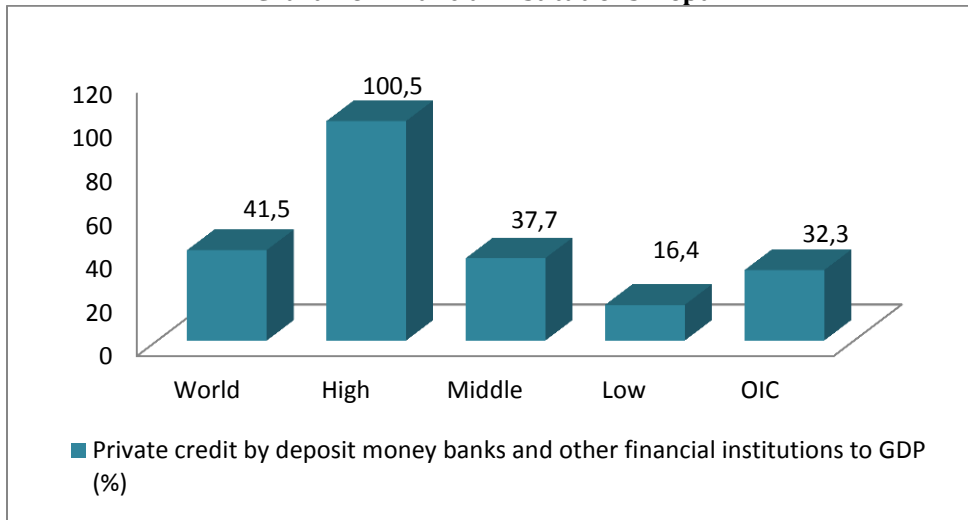
2.2.2. Features of the Financial Sector of OIC MCs

The World Bank's Global Financial Development Report uses four characteristics to assess the status of various aspects of the financial sectors of different countries. Financial institutions and financial markets are evaluated according to their depth, access, efficiency and stability. The status of OIC MCs for each of these characteristics relative to countries in different income groupings are presented below.

Depth

The depth of financial institutions is defined by domestic private credit to the real sector by a deposit of money banks and other financial institutions as a percentage of GDP. Chart 2.6 shows that the average depth of 51 OIC MCs is 32.3% which is lower than the average of the world (41.5%), high income countries (100.5%), and middle income countries (37.7%). Though the OIC MCs average larger than that of low income groups (16.4%), the overall results indicate that their financial institutions are relatively shallow.

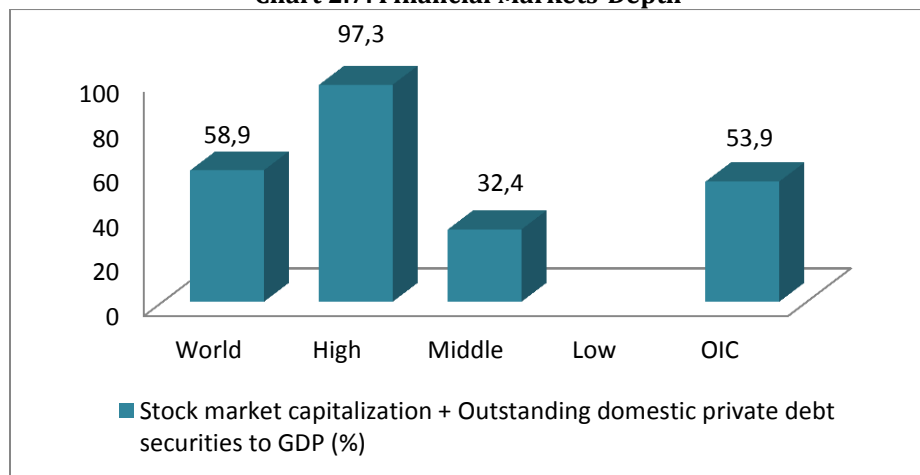
Chart 2.6: Financial Institutions-Depth



Source: Calculated from World Bank Global Financial Development database

The depth of financial markets is measured by the sum of total stock market capitalization and outstanding domestic private debt securities as a percentage of GDP. Chart 2.7 shows that the average depth of financial markets for OIC MCs is 53.9%, which is lower than the world average (58.9%) and high income countries (97.3%). The financial markets in OIC MCs appear to be relatively deeper than the average of middle income countries (32.4%). However, there is a need for caution in reading this result as the average may not be representative for all countries with only four countries having data on private debt securities.

Chart 2.7: Financial Markets-Depth



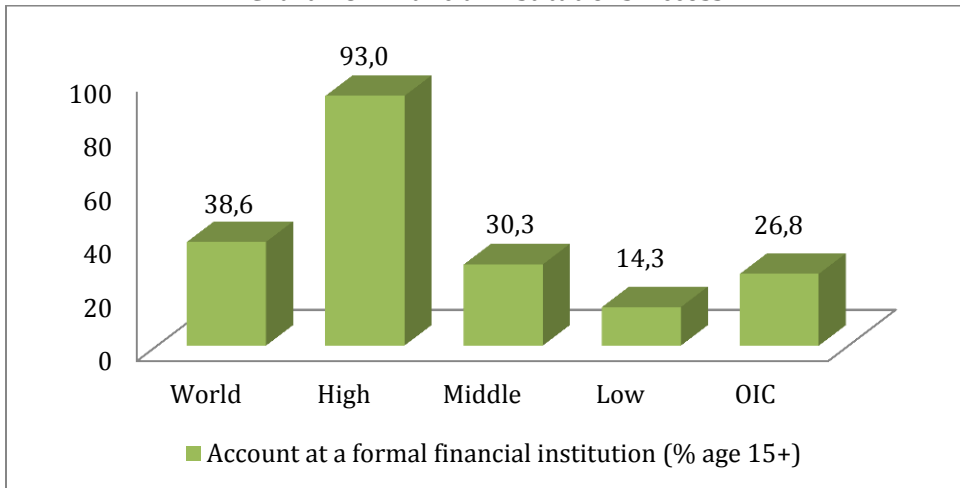
Source: Calculated from World Bank Global Financial Development database

Access

Access to financial institutions is approximated by measuring the percentage of adults (age of more than 15 years) who have accounts at a formal financial institution such as a bank, credit union or other financial institution (such as cooperative, microfinance institution or post office). Chart 2.8 shows that the average access to financial institutions for 49 OIC MCs was

26.8%, which is lower than the world average (38.6%), high income countries (93%), and middle income countries (30.3%). Though the OIC MCs score better than the average for low income countries (14.3%), the number indicates that access to financial institutions in OIC MCs is relatively poor.

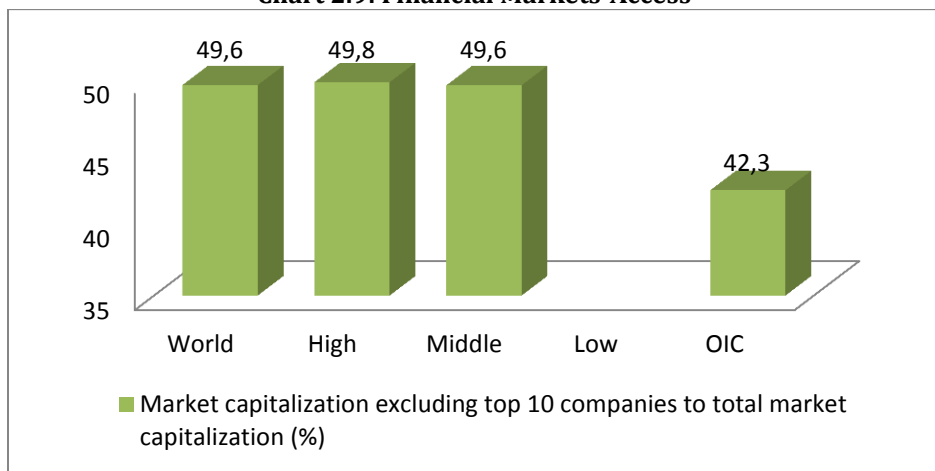
Chart 2.8: Financial Institutions-Access



Source: Calculated from World Bank Global Financial Development database

Access to financial markets is estimated by the ratio of market capitalization excluding the top 10 companies to total market capitalization. While no data is available for low income countries, Chart 2.9 shows that the average access to financial markets for 11 OIC MCs (42.3%) is lower than that of the average for the world (49.6%), high income countries (49.8%), and middle income countries (49.6%), indicating a relatively poor access to financial markets.

Chart 2.9: Financial Markets-Access



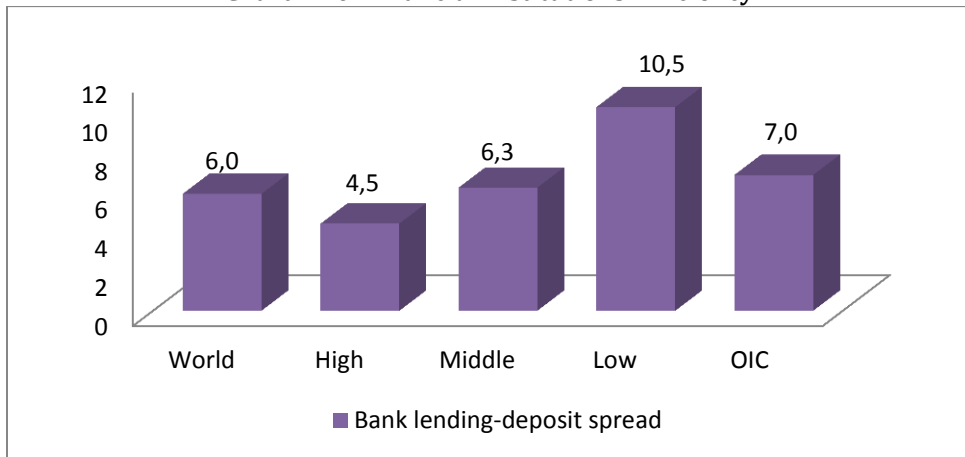
Source: Calculated from World Bank Global Financial Development database

Efficiency

Efficiency of financial institutions is measured by the spread between lending rate and deposit interest rate. The average of lending-deposit spread for 30 OIC MCs (7%) is higher than that of

the world (6%), high income countries (4.5%) and middle income countries (6.3%). Although financial institutions of OIC MCs are more efficient than low income countries (10.5%), the average for spread shows that they are relatively inefficient compared to that of the other income groups and the world average.

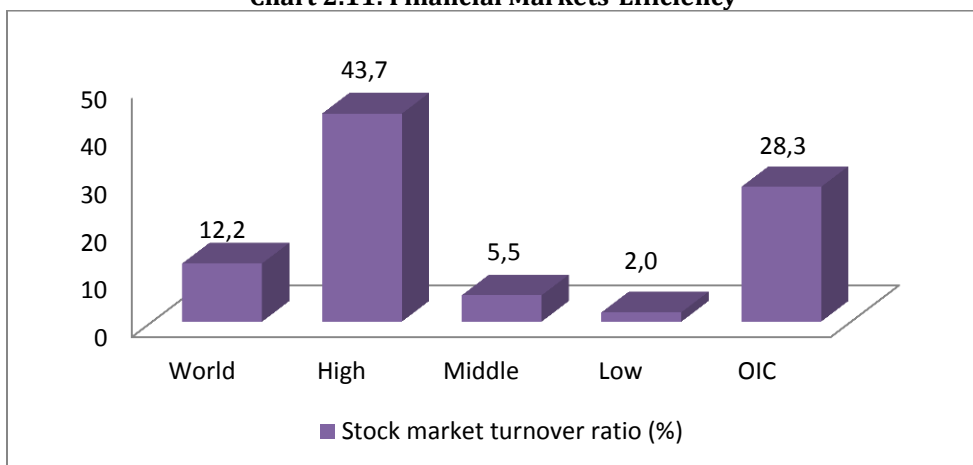
Chart 2.10: Financial Institutions-Efficiency



Source: Calculated from World Bank Global Financial Development database

Efficiency of financial markets is estimated by the stock market turnover ratio which is measured by total value of shares traded during the period over the stock market capitalization. Chart 2.11 shows that the average efficiency of 22 OIC MCs is 28.3%, which is much higher than the average for the world (12.2%), the middle income countries (5.55) and low income countries (2%). The results indicate that financial markets in OIC MCs are relatively more efficient than the world average.

Chart 2.11: Financial Markets-Efficiency

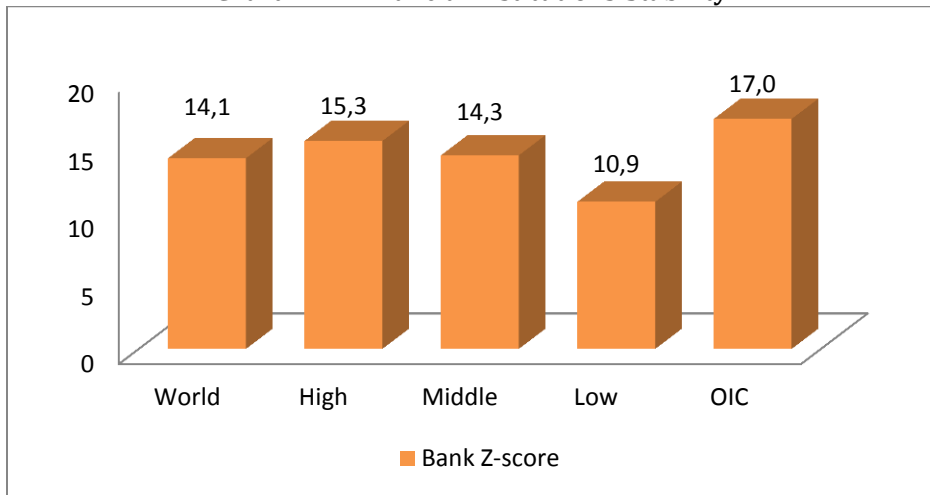


Source: Calculated from World Bank Global Financial Development database

Stability

Stability of financial institutions is estimated by Z-score for commercial banks which is estimated as $[ROA + (\text{equity}/\text{assets})]/\text{standard deviation of ROA}$. Z-score shows the relative strengths of the banking system's buffers (return and equity) compared to the risks (volatility of returns) (WB 2016: 160). Chart 2.12 shows that the average Z-score for 54 OIC MCs is 17, which is the highest compared to all other groupings (average for the world is at 14.1, high income countries at 15.3, middle income countries at 14.3 and low income countries at 10.9). Thus, financial institutions in OIC MCs are relatively more stable on the average compared to their counterparts in the rest of the world.

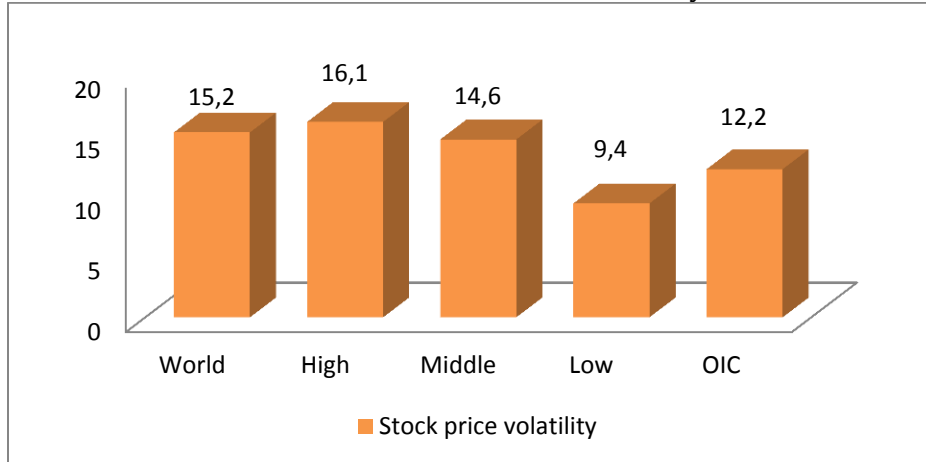
Chart 2.12: Financial Institutions-Stability



Source: Calculated from World Bank Global Financial Development database

Stability of financial markets is measured by a 360-day standard deviation of the return on the national stock market index. Chart 2.13 shows that the average stock price volatility of 18 OIC MCs is 12.2, which is lower than that of world (15.2), high income countries (16.1) and middle income countries (14.6). Even though the volatility of the stock price is lower for low income countries (9.4), the information indicates that financial markets in OIC MCs are relatively stable.

Chart 2.13: Financial Markets-Stability



Source: Calculated from World Bank Global Financial Development database

In summary, the results show that while the banking sector in OIC MCs is close to the world average, the insurance sector is relatively smaller. Similarly, whereas the debt securities market is relatively smaller, the equity market has an average size that is larger than the world average. In terms of various features of the financial sector, the results show that while financial institutions of OIC MCs have a relatively lower depth, access and efficiency, they are more stable. The capital markers appear to have depth that is closer to the world average and have higher efficiency and stability, but their access is lower compared to the world average.

2.3. Islamic Finance: Foundational Principles and Contracts

Islamic law (*Shariah*) is comprehensive and covers various aspects of life including economic dealings. Other than providing legal rules, *Shariah* also provides moral principles relating to economic activities and transactions. It defines the founding concepts of an economic system such as property rights, rationality, and the objectives of economic activities and principles that govern economic behavior and activities of individuals, markets, and the economy. Al-Ghazali identifies the essential goals of *Shariah* (*maqasid al Shariah*) to constitute safeguarding the faith (*din*), self (*nafs*), intellect (*'aql*), posterity (*nasl*), and wealth (*mal*) (Chapra 2006). The objective of Islamic commercial law and an Islamic economy would strive to protect and enhance one or several of the *maqasid*. Specifically, commercial transactions are sanctified and encouraged as they preserve and support property and progeny (Hallaq 2004).

The implications of *maqasid* in an economy and the financial sector can be viewed in different ways. One categorization of *maqasid* would be to classify them at the macro/general level (*maqasid ammah*) and micro/specific level (*maqasid khassah*) (Abozaid 2010, Dusuki 2009, Dusuki and Bouheraoua 2011). While macro/general *maqasid* relates to the benefits and well-being of the overall society, micro/specific *maqasid* deals with issues relating to individual transactions. A brief overview of *maqasid* from these perspectives for the financial sector is presented below.

Maqasid at the macro level is similar to the broader goals of *Shariah* and involve realizing human wellbeing by enhancing *maslahah* (benefit) on the one hand and preventing *mafsadah* (harm) on the other hand (Laldin and Furqani 2012). Different scholars suggest the macro

implications of *maqasid* in a variety of ways. At the broadest level, Abozaid (2010: 67) views it as a vision that protects and preserves public interests in all aspects and segments of life. Fulfilling the *maqasid* at this level would imply that an economy should ensure growth and stability with equitable distribution of income, where all households earn a respectable income to satisfy basic needs (Chapra 1992). Achieving the objectives of optimal growth and social justice in an Islamic economy would require universal education and employment generation (Naqvi 1981: 85).

The micro-*maqasid* relates to specific issues arising in the operations and transactions of the Islamic financial sector. Using various legal maxims, Dusuki and Abdullah (2007) and Dusuki and Bouheraoua (2011) conclude that prevention and minimizing harm should be a key objective of an Islamic firm. These would include not engaging in harmful activities such as selling products that harm the consumer, dumping toxic waste harmful to the environment or residential areas, engaging in speculative ventures, etc. *Maqasid* at the micro or product level also implies *Shariah* compliance and fulfilling the objectives of contracts. Kahf (2006) views *maqasid* in transactions as fulfilling the objectives stipulated in contracts. These include upholding property rights, respecting consistency of entitlements with the rights of ownership, linking transactions to real life activity, transfer of property rights in sales, prohibiting debt sale, etc.

Two key principles governing Islamic financial transactions are that financing is closely linked to the real economy and returns are associated with risks in real transactions. The legal maxims of 'benefit of a thing is a return for the liability for loss from that thing' (*al-kharaj bi al-daman*) and 'the detriment is as a return for the benefit' (*al-ghurm bi al-ghunm*) (Majallah Articles 85 and 87) link 'entitlement of gain' to the 'responsibility of loss' (Kahf and Khan 1988: 30). The implications of these maxims is a preference for profit-loss sharing instruments and also that the party enjoying the full benefit of an asset or object should bear risks of the ownership (Vogel and Hayes 1998).

2.3.1. Islamic Modes of Financing

Traditional Islamic modes of financing can be broadly classified into equity and debt instruments. While equity instruments are *mudarabah* and *musharakah*, debt-instruments arise from sale transactions. These fixed-income instruments include *murabahah* (cost-plus or mark-up sale), *bai-muajjal/murabahah* (price-deferred sale), *istisna/salaam* (object deferred sale or pre-paid sale) and *ijarah* (leasing).⁶ We outline the basic concepts and properties of these instruments below.

a) *Murabahah/Bai Muajjal*: *Murabahah* is a sale contract at a mark-up. The seller adds a profit component (mark-up) to the cost of the item being sold. When the purchase is on credit and the payment for a good/asset is delayed, then the contract is called *bai-muajjal*. A variant would be a sale where the payments are made in instalments. These contracts create debt that can have both short and long-term tenors. In these debt contracts, the supplier of the good has a claim on a fixed amount that must be paid before arriving at a profit.

⁶For a discussion on these modes of financing see Ayub (2011) and Usmani (1999).

- b) *Salam*: The *Salam* sale is an advance purchase or product-deferred sale of a generic good. In a *salam* contract, the buyer of a product pays in advance for a good that is produced and delivered later. The contract applies mainly to agricultural goods.
- c) *Istisna*: The *Istisna* contract is similar to the *salam* contract with the difference that the goods are produced according to the specifications given by the buyer. This applies mainly to manufactured goods and real estate. In *istisna*, the client asks the financier to provide an asset (like real estate) and the payments are made over a period of time in the future. In this case, the financier may need to have a parallel *istisna* and sub-contract the project to a third party for its completion. In *istisna* the payments can be made in installments over time with the progression of the production.
- d) *Ijarah*: *Ijarah* is a lease contract in which the lessee pays rent to the lessor for use of usufruct. In *ijarah* the ownership and right to use an asset (usufruct) are separated. It falls under a sale-based contract as it involves the sale of usufructs. A lease contract that results in the transfer of an asset to the lessee at the end of the contract is called *ijarah wa iqtina* or *ijarah muntahia bittamleek*. *Ijarah wa iqtina* combines sale and leasing contracts and uses hire-purchase or rent-sharing principles. The ownership of the asset is transferred to the lessee as payments for the asset are also made along with the rent. After the contract period is over, the lessee assumes the ownership of the asset. Note that in a simple *ijarah*, the rental payments made are captured in the current liabilities in the balance sheet. In case of *ijarah wa iqtinah*, however, the leased item would be in the form of a debt during the period of lease.
- e) *Musharakah*: *Sharikah* is a partnership between parties in which financial capital and/or labor act as shared inputs and profit is distributed according to the capital share of the partners or in some agreed upon ratio. The loss, however, is distributed according to the share of the capital. Though there can be different kinds of partnerships based on money, labor, and reputation, one case of *sharikah* is participation financing or *musharakah* in which partners share both in capital and management of the business enterprise. Thus partners in *musharakah* have both control rights and claims to the profit.
- f) *Mudarabah* (or *qirad* or *muqadarah*): *Mudarabah* is similar to the concept of silent partnership in which financial capital is provided by one or more partner(s) (*rab ul mal*) and the work is carried out by the other partner(s) *mudarib*. The financiers and the managers of the project share the profit in an agreed upon ratio. The loss, however, is borne by the financiers according to their share in the capital. The manager's loss is not getting any reward for his services. As the *rab ul mal* is the sleeping partner, he/she has a claim on profit without any say in the management of the firm.

2.4. Islamic Finance: Evolution and International Infrastructure Institutions

2.4.1. Evolution of the Islamic Financial Sector

The first experiments of contemporary Islamic finance began in the countryside of Mit Ghamar in Lower Egypt in 1963. Under the leadership of Ahmed al-Najjar, savings/investment houses operated in small towns in Northern Egypt, providing financing on a profit-loss sharing basis to small entrepreneurs and poor farmers. In the same year, the Pilgrims' Management and Fund Board (Tabung Haji) was established in Malaysia to help people save money to go for the *hajj* (pilgrimage). The funds were used to invest in industrial and agricultural projects. Islamic

finance has diversified and has grown rapidly to become a significant global sector. The evolution of different Islamic financial institutions over time is shown in Table 2.2 and key milestones are discussed below.

Table 2.2: Evolution of Islamic Financial Institutions and Markets

Period	Financial Institutions	Financial Markets
1970s	<ul style="list-style-type: none"> ➤ Banks ➤ Takaful 	
1980s	<ul style="list-style-type: none"> ➤ Retakaful ➤ Mudarabah companies ➤ Microfinance institutions ➤ Cooperatives/Credit Unions 	<ul style="list-style-type: none"> ➤ Mutual Funds
1990s	<ul style="list-style-type: none"> ➤ Private Equity & Venture Capital Firms ➤ Project finance ➤ Pawn shops ➤ Investment banks 	<ul style="list-style-type: none"> ➤ Islamic indices ➤ Corporate sukuk
2000s	<ul style="list-style-type: none"> ➤ Awqaf Properties Investment Fund ➤ Infrastructure fund ➤ Leasing companies 	<ul style="list-style-type: none"> ➤ Sovereign sukuk ➤ Hedge funds ➤ Islamic REITs
2010s	<ul style="list-style-type: none"> ➤ Crowd funding platforms 	

1970s: After the formation of the Organization of Islamic Conference (OIC) in 1973, the Islamic Development Bank (IDB) was established in 1975 in Jeddah, Saudi Arabia. In the same year, the first Islamic commercial bank, Dubai Islamic Bank, was established in UAE. Realizing that conventional insurance had objections from a Shariah point of view, two Islamic insurance companies were launched in 1979, the Islamic Arab Insurance Co. (IAIC) in UAE and the Islamic Insurance Co. in Sudan.

1980s: The 1980s witnessed the launch of a number of non-bank financial institutions. Mudaraba companies were established in Pakistan after the promulgation of the Mudaraba Ordinance 1980. One of the earlier Islamic microfinance institutions was Al-Fallah Aam Unnayan Sangstha in Bangladesh, established in 1989. In non-Muslim countries where banking laws did not allow the establishment of Islamic banks, Islamic cooperatives were introduced. The first Islamic cooperative in the Western world, Ansar and Islamic Co-operative Housing Corporation Ltd. was established in Toronto, Canada in 1981 to provide Shariah compliant home financing to Muslims of the country. The Muslim Credit Union was established in Trinidad and Tobago in 1983 and Pattani Islamic Saving Cooperative started operations in 1987.

Bank ABC, an investment bank based in Bahrain launched its Islamic services in 1987, thus starting Islamic investment banking. With the expansion of takaful companies, retakaful companies emerged in the 1980s (Nuhtay et. al. 2014). Furthermore, larger Islamic financial institutions also emerged during the 1980s that established other financial institutions such as banks, takaful companies and investment banks in different parts of the world. One the first of these institutions was the Dar al Maal Islami Trust that was established in Switzerland in 1981.

In the asset management sector, Amana Income Fund was launched in the US in 1986 as the first Islamic mutual fund.

1990s: Some other types of nonbank financial institutions were established in the 1990s. The first Islamic pawnshop, Muassasah Gadaian Islam Terengganu, was established in the Terengganu state of Malaysia in 1992 (Hisham et. al. 2013). In Islamic project financing, the first major co-financed transaction involving project financing was the USD1.8 billion Hub River power project in Pakistan that started in 1993. Al-Rajhi Banking and Investment Corporation provided a USD92 million Istisna' facility in a total investment of USD 1.8 billion for the project. Similarly, a USD200 million tranche by Kuwait Finance House for a USD2 billion petrochemical plant for the Equate Petrochemical Company was a joint venture between the Union Carbide corporation and the Petrochemical Industries Company, a subsidiary of Kuwait's national oil company in 1996 (Esty 2000). In capital markets, the first corporate sukuk was issued by Shell in Malaysia in 1990. Furthermore, to meet the demand of Muslim investors, the Dow Jones Islamic index was also launched in 1999.

2000s: IDB established the Awqaf Properties Investment Fund in 2001 to invest in developing awqaf properties in different parts of the world on a commercial basis. In the same year, IDB also launched the first infrastructure fund with a capital commitment of USD 730 million.⁷ Injazat Technology Fund E.C established in Dubai in 2001 was one of the first Islamic venture capital funds. In Asia, CIMB Muamalat Fund I was the first Islamic private equity fund founded in 2002 (Wouters 2008). Islamic leasing companies started in 2000 and since then several have been established in the GCC region (Henry 2012). A few Islamic hedge funds were also structured and marketed after the mid-2000s, but these did not get traction due to a lack of demand (Gassner 2007). After the publication of Guidelines for Islamic Real Estate Investment Trusts (REITs) by the Securities Commission of Malaysia in 2005, the first Islamic REIT AlAqar KPJ REIT valued at RM 481 was issued in the country in 2006.

2010s: Among the key innovations in Islamic financial institutions after 2010 were crowd-funding platforms. While Liwwa was an asset based platform launched in Jordan in 2013, Shekra was an equity based crowd funding platform launched in Egypt in the same year (CCA and FCA 2013).

2.4.2. Supporting International Infrastructure Institutions

The progression of different international infrastructure institutions supporting the Islamic financial sector over the years is shown in Table 2.3. The infrastructure institutions classified according to the architectural features identified in Chapter 1 are discussed below.

Legal Infrastructure

The International Islamic Center for Reconciliation and Commercial Arbitration (IICRCA) was established in Dubai, UAE in 2004 and started operations in 2007. The goal of IICRCA is to

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<http://www.isdb.org/irj/portal/anonymous?NavigationTarget=navurl://88145b5fdaf722f11d9b39ed380b40f1&LightDTNKnobID=73561714>

provide an alternative dispute resolution and reconciliation platform to settle cases applying Islamic law for disputes arising in Islamic financial industry.

Regulatory Standard Setting Bodies

The Islamic Financial Services Board (IFSB) was established in 2002 in Kuala Lumpur, Malaysia as a regulatory standard setting body for Islamic banks, takaful and capital markets by introducing new, or adapting existing, international standards consistent with *Shariah* principles. IFSB promotes the development of a prudent and transparent Islamic financial services industry to ensure the soundness and stability of the industry. As of December 2015, IFSB has published 24 standards that include 17 Standards and Guiding Principles, 6 Guidance Notes and one Technical Note.

The International Islamic Financial Markets (IIFM) was established in 2002 in Bahrain as a global standard setting body focusing on 'standardization of Islamic financial contracts and products templates relating to the capital and money market, corporate finance and trade finance'.⁸ To date, IIFM has published seven standards of different products.

Shariah Related

One of the key Islamic jurisprudential institutions is the Islamic Fiqh Academy (IsFA) established in 1981 in Jeddah, Saudi Arabia under the auspices of the OIC. Though IsFA issues Islamic legal rulings on different issues, it also covers Shariah rulings in economic and financial matters that are relevant for the Islamic financial sector.

Though Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) were first established to develop accounting, and auditing for Islamic financial institutions, it also develops and publishes Shariah standards for Islamic financial contracts. To date, AAOIFI has published 54 Shariah standards and four Shariah governance standards.

⁸ http://www.iifm.net/about_iifm/corporate-profile

Table 2.3: Architectural Features and Islamic Infrastructure Institutions

Architectural Features	Infrastructure Institutions
Legal Infrastructure	➤ International Islamic Center for Reconciliation and Commercial Arbitration (IICRCA) , (2004) Dubai, UAE (alternative dispute resolution platform for Islamic finance using Islamic law)
Regulatory Standards	<ul style="list-style-type: none"> ➤ Islamic Financial Services Board (IFSB), (2002) Kuala Lumpur, Malaysia (standard-setting body for regulations and supervision of Islamic banking, takaful and Islamic capital markets) ➤ International Islamic Financial Markets (IIFM), (2002) Bahrain (develop contracts for Islamic capital markets, corporate finance and trade finance)
Shariah related	<ul style="list-style-type: none"> ➤ Islamic Fiqh Academy (IsFA), (1981) Jeddah, Saudi Arabia (issue Islamic legal resolutions on different issues including Islamic finance) ➤ Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), (1991) Bahrain (develop Shariah standards for Islamic finance)
Liquidity Infrastructure	<ul style="list-style-type: none"> ➤ Liquidity Management Center (LMC), (2002) Bahrain (develop Islamic inter-bank money markets and liquidity instruments) ➤ International Islamic Liquidity Management Corporation (IILM), (2010) Kuala Lumpur, Malaysia (develop and issue short-term Islamic instrument for cross-border liquidity management)
Information Infrastructure	<ul style="list-style-type: none"> ➤ Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), (1991) Bahrain (develop accounting and auditing standards for Islamic finance) ➤ Islamic International Rating Agency (IIRA), (2002) Bahrain (provide credit and Shariah ratings)
Knowledge and Human Capital	<ul style="list-style-type: none"> ➤ Islamic Research & Training Institute (IRTI), (1983) Jeddah, Saudi Arabia (promote research & training in Islamic economics & finance) ➤ World Bank Global Islamic Finance Development Center (GIFDC), (2013) Istanbul, Turkey (conduct research, training, advisory services for development of Islamic finance)
Facilitating Institutions	<ul style="list-style-type: none"> ➤ Islamic Development Bank (IDB), (1975) Jeddah, Saudi Arabia (promote economic development in member countries and Islamic finance) ➤ General Council of Islamic Banks and Financial Institutions (CIBAFI), (2001) Bahrain (trade association of Islamic financial institutions to enhance best practices)

Source: Webpages of organizations.

Liquidity Infrastructure

The Liquidity Management Centre (LMC) was established in Bahrain in 2002 to help Islamic financial institutions manage their liquidity mismatch through money-markets and short and medium term liquid investments by providing short and medium term Shariah compliant instruments.

The International Islamic Liquidity Management Corp. (IILM) was established in 2010 in Malaysia to create and issue short-term *Shariah*-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. The goal of IILM is also to foster

international cooperation to build Islamic liquidity management infrastructure at national and international levels.

Information Infrastructure

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was first established as the Financial Accounting Organization for Islamic Banks and Financial Institutions in 1991 in Bahrain by Islamic financial institutions to develop accounting, auditing and governance standards for Islamic financial institutions. Other than the Shariah standards, AAOIFI has issued 27 financial accounting standards, 7 governance standards, 2 codes of ethics and one guidance note.

The Islamic International Rating Agency (IIRA) was established in Bahrain in 2005 to carry out ratings for Islamic financial institutions and Islamic capital market products by incorporating the unique features of Islamic finance. Other than providing credit ratings, IIRA also carries out *Shariah* Quality Rating (SQR) to assess the status of Shariah compliance in different financial institutions.

Human Capital and Knowledge Development

The Islamic Research and Training Institute (IRTI) was established by Islamic Development Bank in 1983 to undertake and advance research and training that would enable economic, financial and banking activities conforming to Shariah and promote economic growth and development. One of the key functions of IRTI includes helping to develop a dynamic and innovative Islamic financial services industry by contributing to basic and applied research.

The Global Islamic Finance Development Center of the World Bank based in Istanbul Turkey was inaugurated in 2013. The Center is a knowledge hub for conducting research and training and providing technical assistance and advisory services to World Bank Group client countries interested in developing Islamic financial institutions and markets.

Facilitating Institutions

The Islamic Development Bank established in 1975 was one of the first Islamic financial institutions with an objective to 'foster socioeconomic development in member countries and Muslim communities in non-Member countries in accordance with the principles of the Shariah'.⁹ One of the strategic thrusts of the Islamic Development Bank identified in its Vision 1440H document was to 'Expand the Islamic financial industry'. Over the years, IDB has been instrumental in not only coming up with innovative instruments (such as Awqaf Properties Investment Fund and Infrastructure funds), but it also has been instrumental in establishing the key infrastructure institutions identified above (such as IICRCA, IIFM, IFSB and IILM).

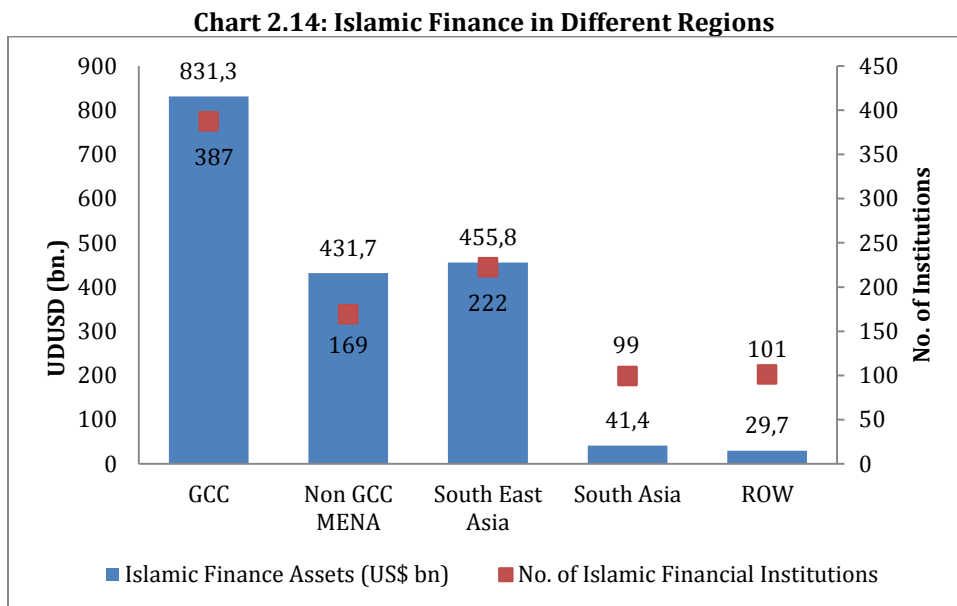
Based in Bahrain, the General Council for Islamic Banks and Financial Institutions (CIBAFI) was established in 1981 as a global association of Islamic financial institutions. CIBAFI aims to foster sound industry practices among financial institutions and also promote the development

⁹<http://www.isdb.org/irj/portal/anonymous?NavigationTarget=navurl://eb226e0b9a3297ebddcc5554057dd35f>.

of the Islamic financial sector using advocacy, research awareness and information sharing and professional development.

2.5. Global Status of Islamic Finance: An Overview

Chart 2.14 shows the regional distribution of Islamic finance.¹⁰ Note that the countries included in different regions, except for rest of the world (ROW), constitute 97% of the global Islamic finance assets. GCC is clearly the leading region for Islamic finance with assets worth USD 831.3 billion managed by 387 financial institutions. South East Asia has a total of 222 Islamic financial institutions with assets valued at USD 455.8 billion followed by the Non-GCC MENA countries that have 169 Islamic financial institutions with assets of USD 431.7 billion. South Asia has 99 Islamic financial institutions holding assets worth USD 41.4 billion. The remaining countries (ROW) have 101 Islamic financial institutions with assets valued at USD 29.7 billion.



Source: Calculated from data provide in ICD and TR (2015)

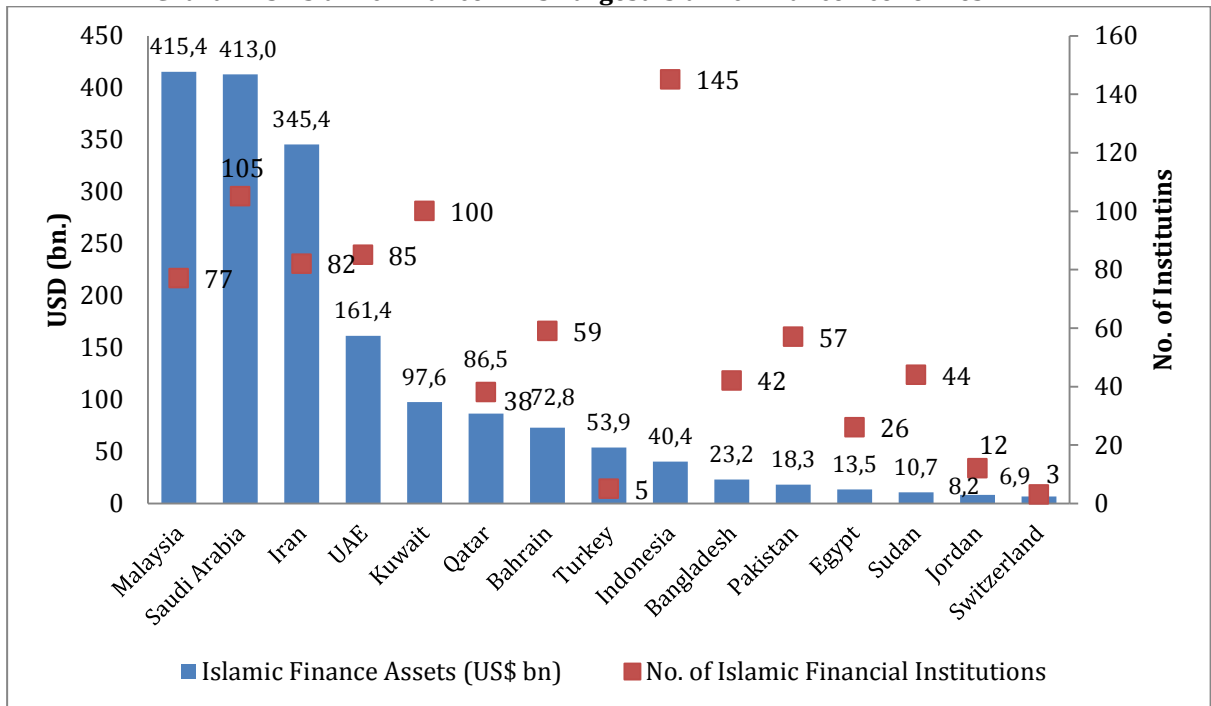
2.5.1. Islamic Financial Institutions

Chart 2.15 shows the distribution of Islamic financial assets among the largest 15 Islamic finance economies. Malaysia has the largest share of Islamic financial assets valued at USD 415.4 billion managed by a total of 77 Islamic financial institutions, and this is followed by Saudi Arabia that has 105 financial institutions managing USD 413 billion of Islamic financial assets. Iran, a country with an Islamic financial system, has the third largest Islamic financial sector with USD 345 billion assets managed by 82 financial institutions. This is followed by four GCC countries (UAE, Kuwait Qatar and Bahrain) which have significant Islamic financial

¹⁰ The countries included in the different regions are the following: GCC — Bahrain, Kuwait, Qatar, Saudi Arabia and UAE; Non-GCC — MENA-Egypt, Iran, Jordan, Sudan and Turkey; South East Asia — Indonesia and Malaysia; South Asia — Bangladesh and Pakistan; ROW (Rest of the World) — all other countries.

sectors. These four countries together have 282 Islamic financial institutions managing USD 418.4 billion worth of assets. Though the financial sector of Sudan is Islamic, it has 44 financial institutions with Islamic financial assets valued at USD 10.7 billion. It is worth noting that Switzerland is the only non-Muslim country that makes the list of those with a significant Islamic financial sector with 3 Islamic financial institutions holding USD 6.9 billion of assets.

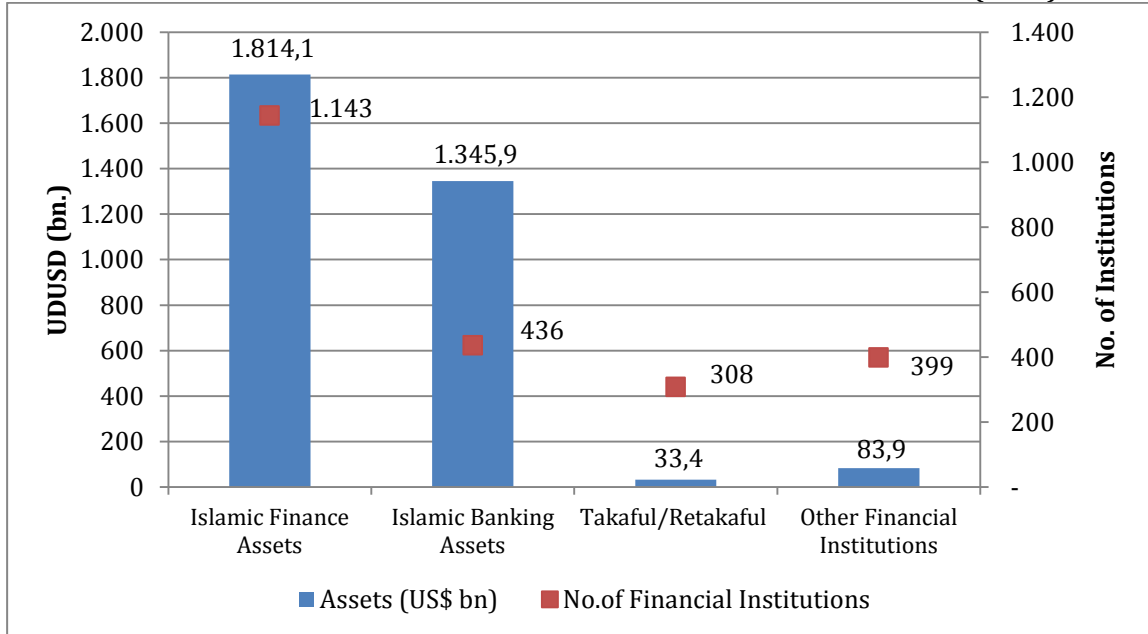
Chart 2.15: Islamic Finance in 15 Largest Islamic Finance Economies



Source: Calculated from ICD and TR (2015)

Chart 2.16 shows the total Islamic financial assets and their distribution among different financial institutions in 2014. The total global Islamic finance assets were USD 1.814 trillion managed by 1,143 Islamic financial institutions. The dominant sector was the Islamic banking sector with assets under the management of USD 1,345.9 trillion and 436 Islamic banks. The takaful and retakaful sector is relatively small with 308 companies holding USD 33.4 billion in assets. A relatively smaller size of takaful assets is reflective of the overall smaller size of the insurance industry discussed above. There were 399 other Islamic financial institutions such as investment banks, leasing companies, finance companies, etc. with assets valued at USD 83.9 billion.

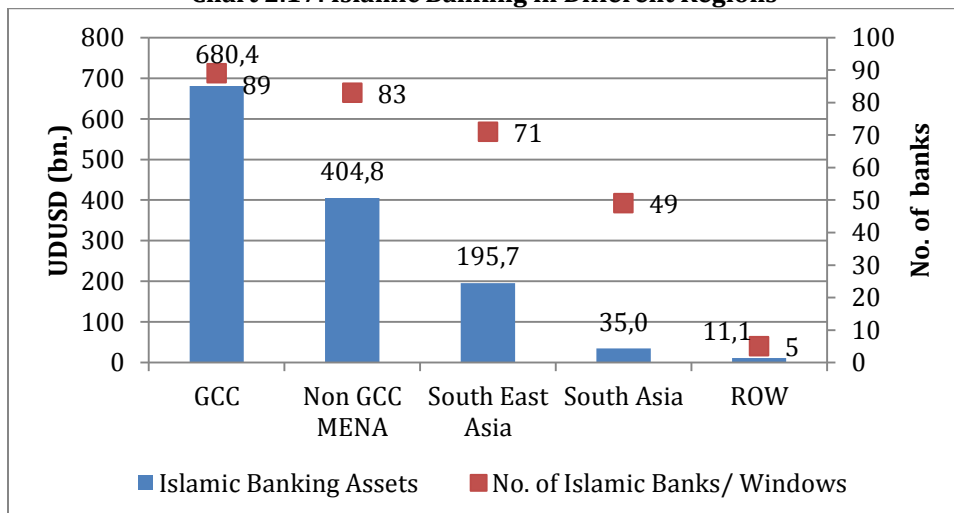
Chart 2.16: Global Islamic Financial Sector -Islamic Financial Institutions (2014)



Source: Calculated from ICD and TR (2015)

Chart 2.17 shows the Islamic banking sector in different regions of the world. With 89 Islamic banks holding assets worth USD 680.4, GCC leads the regions followed by non-GCC MENA countries that have 83 Islamic banks managing USD 404.8 billion assets. Islamic banking assets in South East Asia are worth up to USD 195.7 billion held by 71 countries, and 49 Islamic banks in South Asia hold assets worth USD 35 billion. The rest of the world has 5 Islamic banks holding USD 11.1 billion assets.

Chart 2.17: Islamic Banking in Different Regions

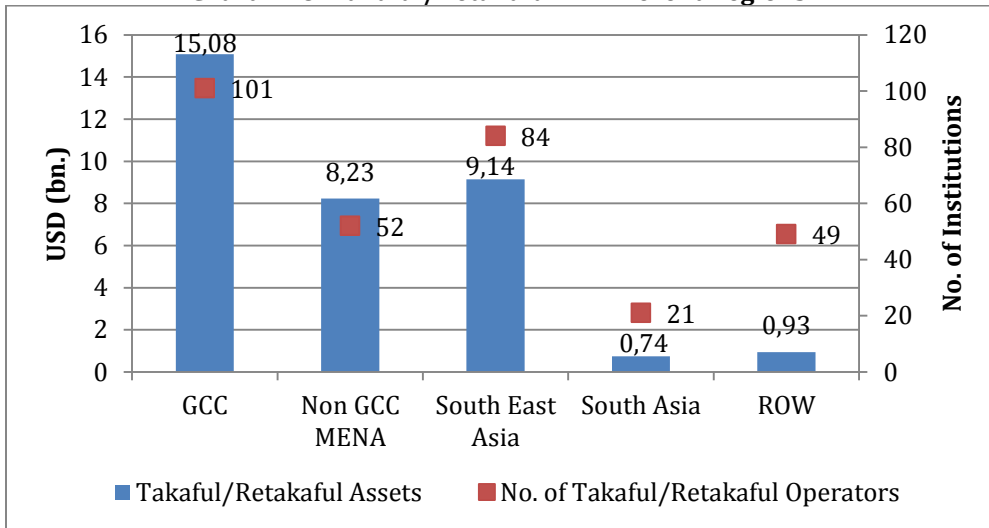


Source: Calculated from data provide in ICD and TR (2015)

Chart 2.18 shows that the takaful/retakaful sector is also largest in the GCC and has 101 companies with assets of USD 15.08 billion. South East Asia has the second largest takaful

sector with 84 companies holding USD 9.14 billion assets followed by non-GCC MENA countries that have 52 takaful companies with assets valued at USD 8.23 billion. While takaful sector assets in South Asia are worth USD 0.74 billion and are held by 21 companies, there are 49 takaful organizations in the rest of the world with assets worth USD 0.93 billion.

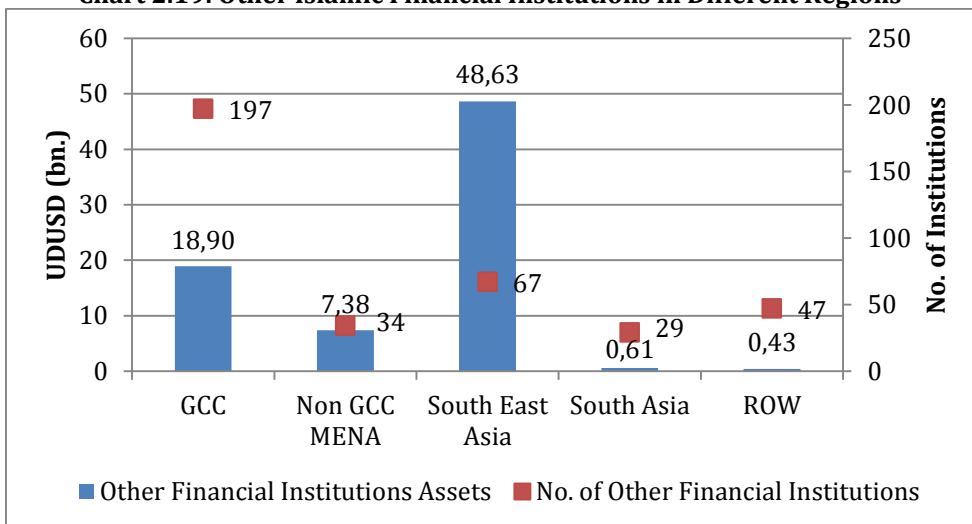
Chart 2.18: Takaful/Retakaful in Different Regions



Source: Calculated from data provide in ICD and TR (2015)

Chart 2.19 shows the status of other Islamic financial institutions in different regions of the world. As indicated, these non-bank financial institutions include investment banks, leasing companies, finance companies, etc. The GCC region also dominates this sector with 197 non-bank Islamic financial institutions holding assets valued at USD 18.90 billion. South East Asia has 67 Islamic financial institutions with USD 48.63 billion assets and the non-GCC MENA region has 34 institutions holding assets worth US\$ 7.38 billion. There are 47 non-bank Islamic financial institutions that hold USD 0.43 billion assets in the countries outside these regions.

Chart 2.19: Other Islamic Financial Institutions in Different Regions



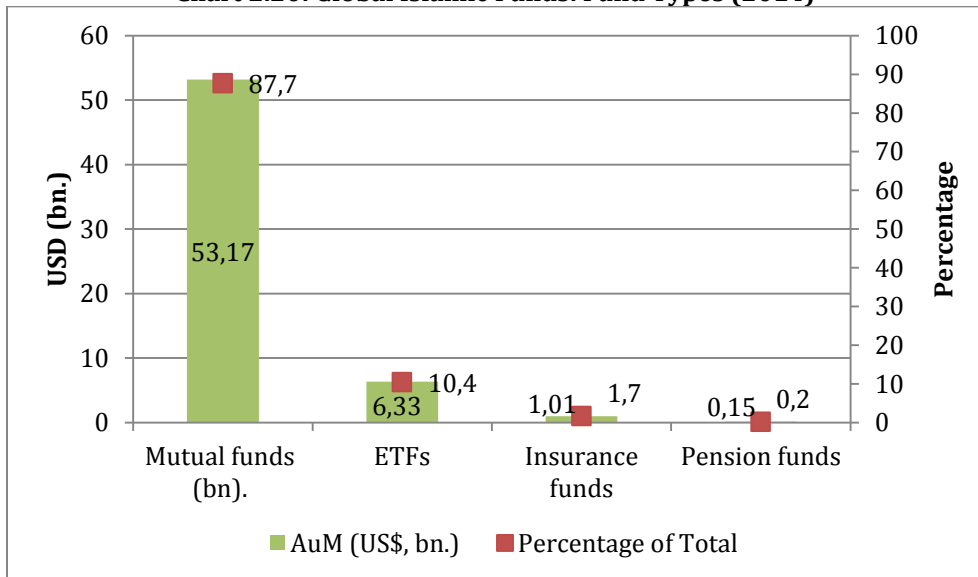
Source: Calculated from data from ICD and TR (2015)

2.5.2. Islamic Financial Markets

Islamic Funds

After providing information on various aspects of the Islamic funds segment of capital markets, this section presents the initiatives taken in 2014. There were a total of 1,181 Islamic funds with a total value of USD 60.65 billion in 2014. Table 2.20 shows the distribution of the Islamic funds according to their types. Mutual funds constitute the bulk (87.7%) of the Islamic funds valued at USD 53.17 billion, and this is followed by ETFs worth USD 6.33 billion which constitute 10.4% of total Islamic funds. Insurance funds and pensions funds are still very small with the former having assets of just over USD 1 billion and the latter having a minuscule amount of only USD 0.15 billion.

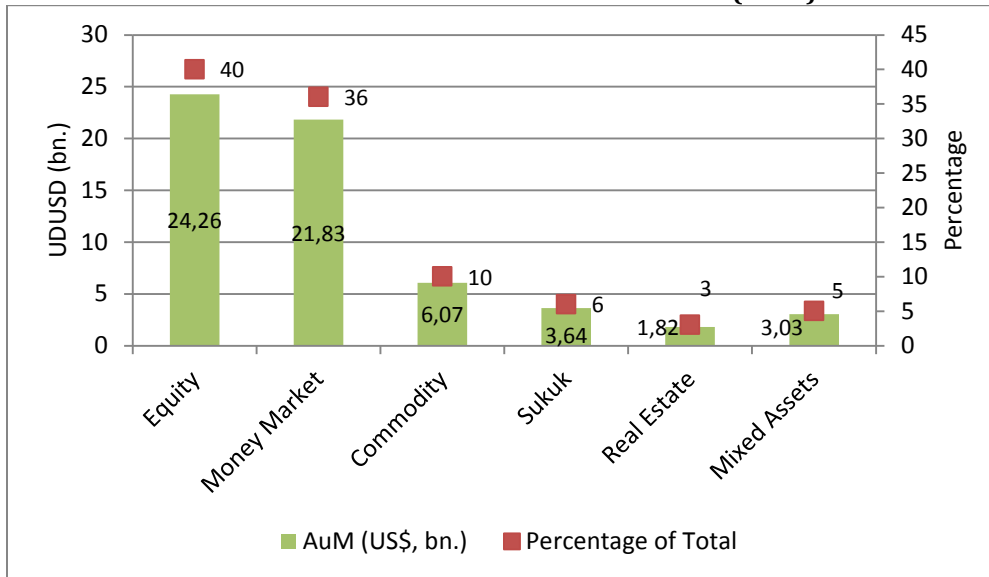
Chart 2.20: Global Islamic Funds: Fund Types (2014)



Source: Calculated from Thomson Reuters Global Islamic Asset Management Outlook 2015

Table 2.21 shows the asset classes of different Islamic funds. Equity based funds equal USD 24.26 billion (constituting 40% of the total) followed by money market funds of USD 21.83 billion constituting 36% of the total Islamic funds. Commodity funds and sukuk funds are valued at USD 6.07 and USD 3.64 billion and together are 16% of the total. The remaining Islamic funds are in the form of real estate funds (USD 1.82 billion) and mixed funds (3.03 billion).

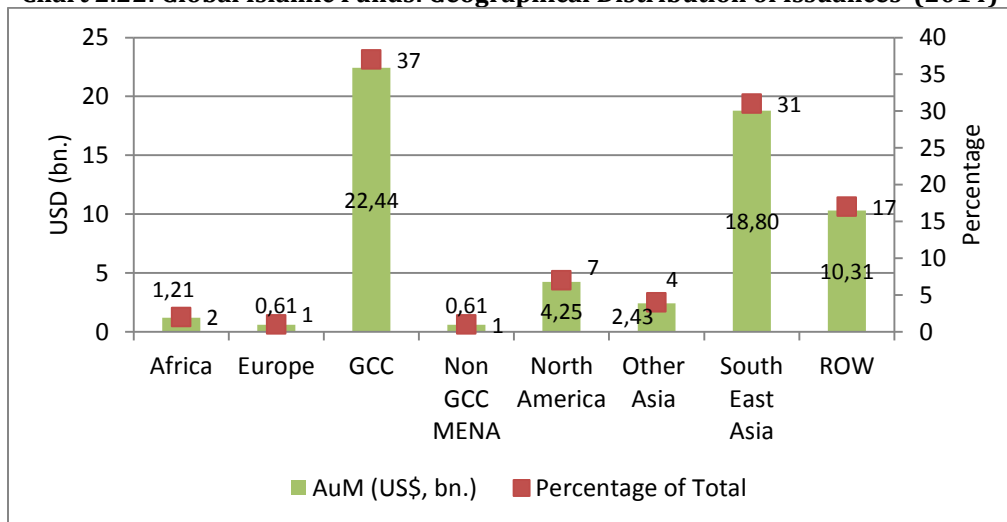
Chart 2.21: Global Islamic Funds: Asset Class (2014)



Source: Calculated from Thomson Reuters Global Islamic Asset Management Outlook 2015

Chart 2.22 shows the geographical distribution of Islamic funds. The GCC region is the host to most (37%) of the funds worth USD 22.44 billion followed by South East Asia with funds of USD 18.8 billion. The assets under management of the rest of the world (ROW) amount to USD 10.31 billion (17%) with North America being at USD 4.25 billion (7%) and the remaining regions having less than 5% of the funds.

Chart 2.22: Global Islamic Funds: Geographical Distribution of Issuances (2014)

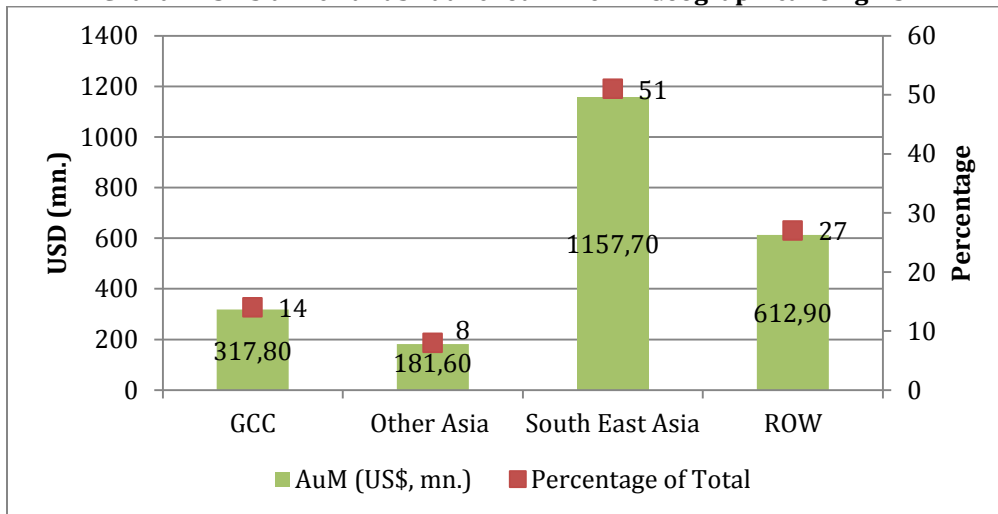


Source: Calculated from Thomson Reuters Global Islamic Asset Management Outlook 2015

During the year 2014, a total of 100 new funds worth USD 2.27 billion were launched. Charts 2.23 and 2.24 show the status of Islamic funds for the year 2014 with the former showing the geographical origins of the new funds launched during the year and the latter showing their asset classes. The bulk of the new sukuk issued in 2014 (USD 1157.7 million) originated from South East Asia. While GCC launched funds were worth USD 317.80 million (14% of the total)

and other Asian countries USD 181.6 million (8% of the total), the remaining funds worth USD 612.0 million constituting 27% of the total for 2014 were initiated in other countries (ROW).

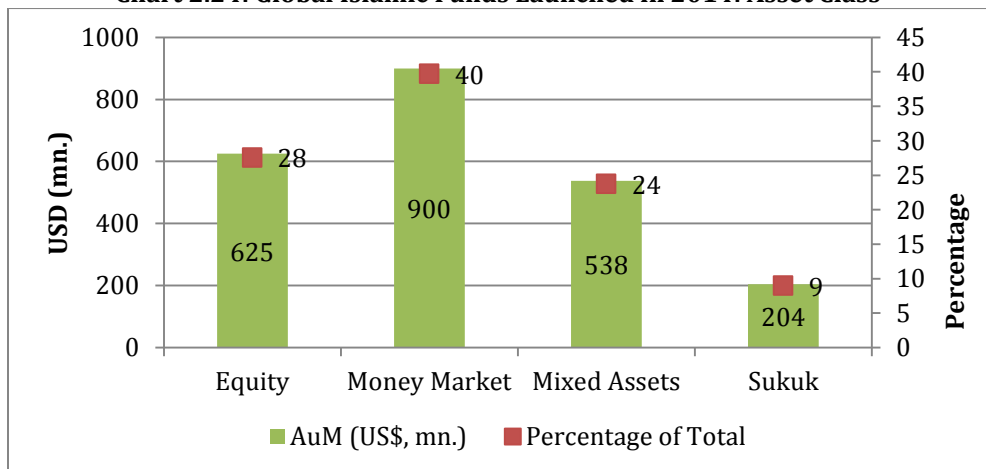
Chart 2.23: Islamic Funds Launched in 2014: Geographical Origins



Source: Calculated from Thomson Reuters Global Islamic Asset Management Outlook 2015

Chart 2.24 presents the asset classes of the funds that were launched in 2014. The bulk of the funds (40%) worth USD 900 million were money market funds and 28% valued at USD 625 million were equity-based funds. A total of USD 538 million sukuk-based funds (24%) were initiated during the year. The remaining 9% of the funds were mixed funds valued at USD 204 million.

Chart 2.24: Global Islamic Funds Launched in 2014: Asset Class



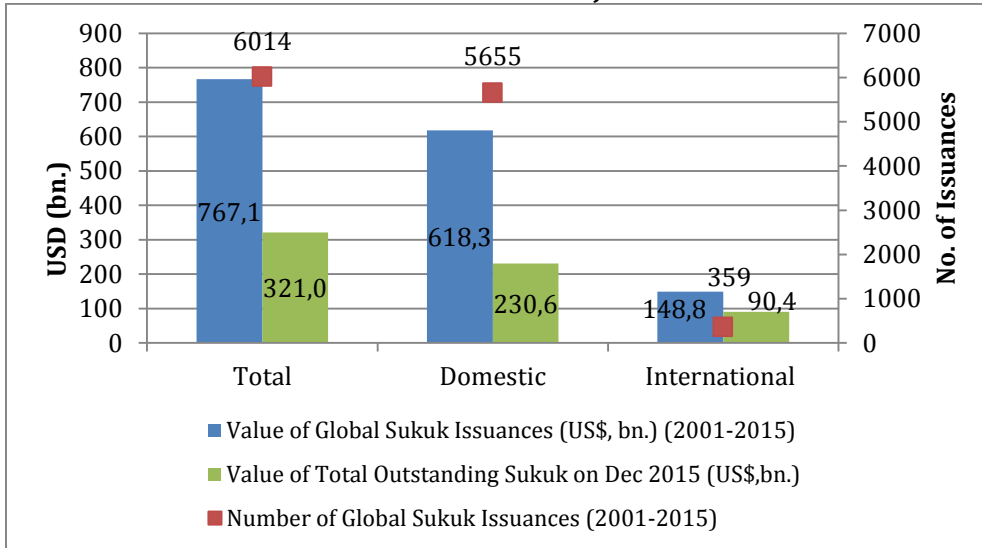
Source: Calculated from Thomson Reuters Global Islamic Asset Management Outlook 2015

Sukuk

The total number of sukuk issued globally between 2001-2015 was 6014 valued at USD 767.1 billion. Of these, 5655 sukuk worth USD 618.3 billion (or 80.6%) were domestic and 359 sukuk worth USD 148.8 (19.4%) were international. The total outstanding value of the sukuk in

December 2015 was USD 321 billion with USD 230.6 billion being domestic and the remaining USD 90.4 billion being international.

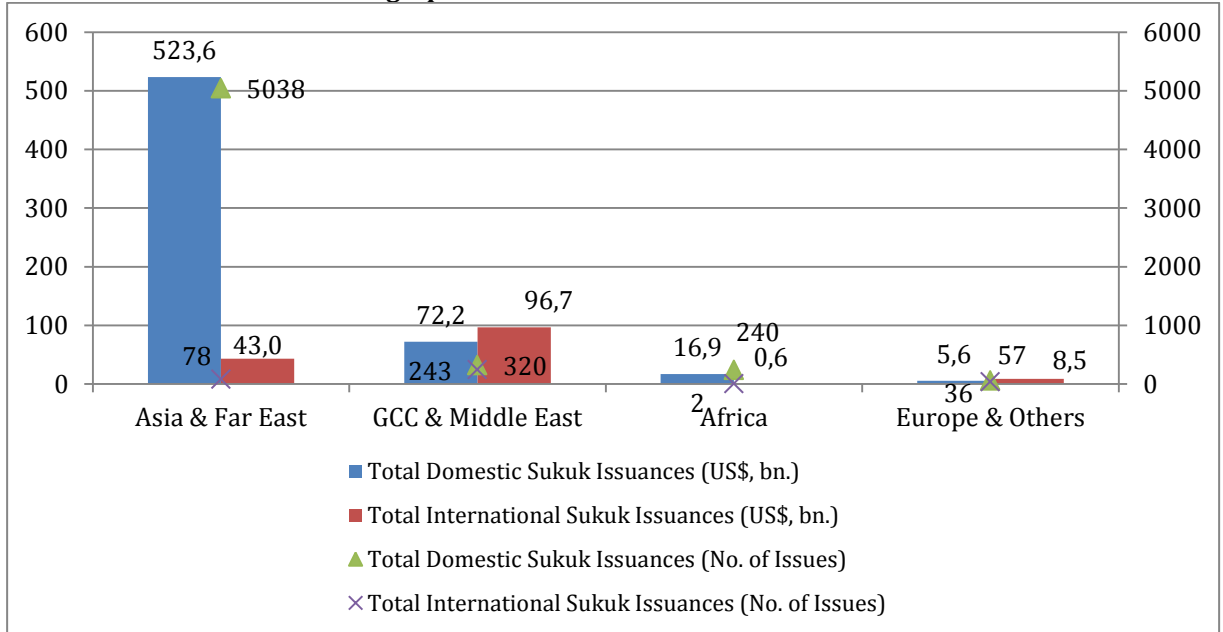
Chart 2.25: Global Sukuk Issuance Jan 2001-Dec 2015



Source: Calculated from IIFM Sukuk Report 2016

Chart 2.26 shows the geographical distribution of global sukuk issuances during 2001-2015. The largest number of sukuk issued was from Asia and the Far East with a total of 5116 (5038 domestic and 78 international) sukuk valued at USD 566.6 billion (USD523.6 billion domestic and USD43 billion international) being issued during the period. The GCC and Middle East issued the second largest number of sukuk (563) distributed into 320 international sukuk valued at USD 96.7 billion and 243 domestic sukuk worth USD72.7 billion. The rest of the world, including Africa and Europe, had a relatively lower number of sukuk, issuing a total of 335 (297 domestic and 38 international) sukuk with a value of USD 31.6 billion (USD 22.4 billion domestic and USD 9.2 billion international).

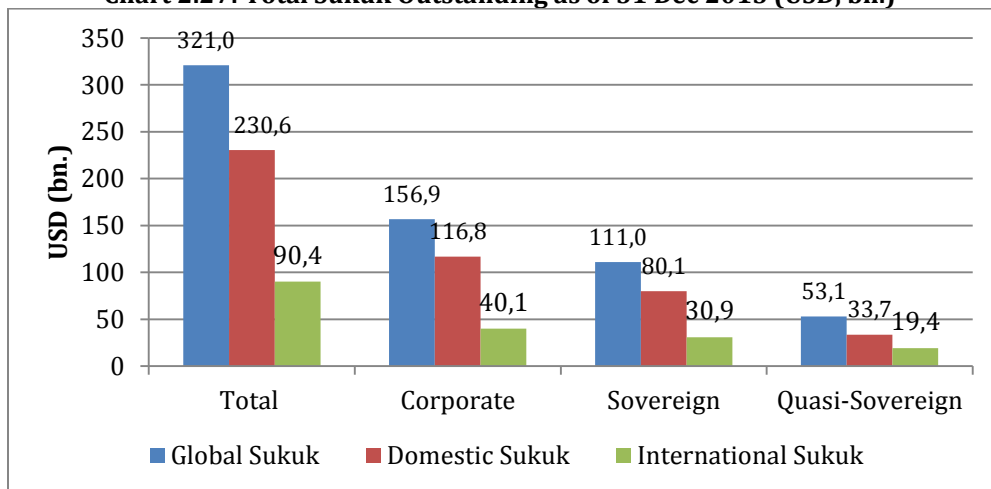
Chart 2.26: Geographical Distribution of Global Sukuk Issues



Source: Calculated from IIFM Sukuk Report 2016

Charts 2.27 and 2.28 show sukuk issuances by different types of issuers, with the former showing the total sukuk outstanding as of 31 December 2015 and the latter showing the issuances in 2015. Chart 2.27's depiction of the total sukuk outstanding as of December 2015 was USD 321 billion of which USD 230.6 billion were domestic and USD 90.4 billion were international. The distribution of the outstanding balances of the total was highest for the corporates (USD 156.9 billion) followed by sovereign (USD 111 billion) and quasi-sovereign (USD 53.1 billion). The corresponding figures for domestic and international outstanding sukuk are given in Chart 2.27. Note that while global sukuk indicates the value of all sukuk issued globally, international sukuk are those that are sold beyond national borders to both national and international investors, as opposed to domestic markets only.

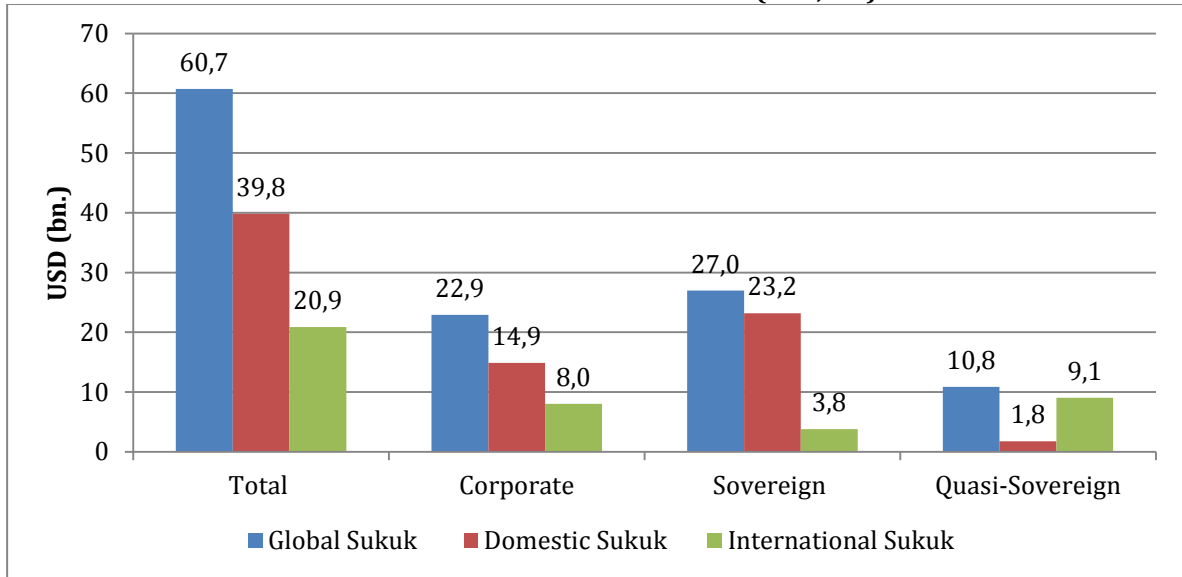
Chart 2.27: Total Sukuk Outstanding as of 31 Dec 2015 (USD, bn.)



Source: Calculated from IIFM Sukuk Report 2016

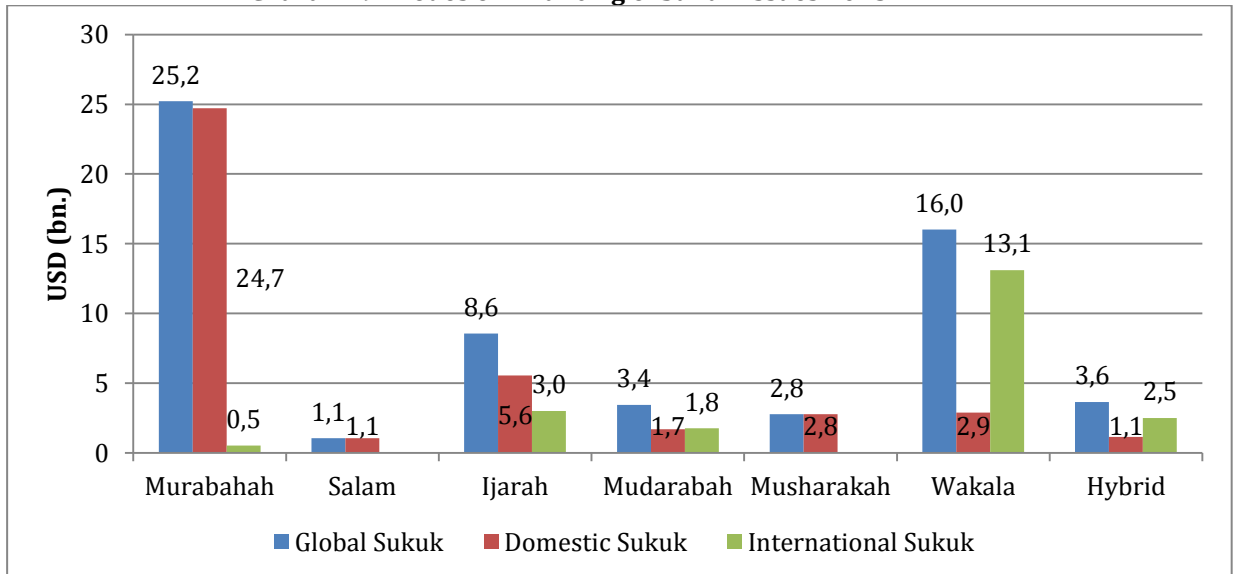
Chart 2.28 shows the distribution of new sukuk among issuers for 2015. A total of USD 60.7 billion worth of sukuk (USD 39.8 billion domestic and USD20.9 billion international) were issued in 2015. The sovereigns issued sukuk valued at USD 27 billion (USD 23.2 billion domestic and USD3.8 billion international) during the year followed by the corporate sector which issued a total of USD22.9 billion (USD 14.9 billion domestic and USD8 billion international). Compared to the previous years, the sovereign appears to have become the dominant issuer during 2015.

Chart 2.28: Global Sukuk Issuance 2015 (USD, bn.)



Source: Calculated from IIFM Sukuk Report 2016

Chart 2.29: Modes of Financing of Sukuk Issues 2015



Source: Calculated from IIFM Sukuk Report 2016

Chart 2.29 presents the different modes of financing that were used for sukuk issued in 2015 across different issuers. Murabahah was the mode for sukuk issues worth USD 25.2billion (of which USD 24.7 was domestic sukuk) during the year making it the most common contractual mode. Wakala was the second most dominant mode used with sukuk valued at USD 16 billion, of which USD 13.1billion were international. Thus, while murabahah is the most popular for domestic sukuk, wakala seems to be the preferred mode for international sukuk issues. Equity based modes of financing (mudarabah and musharakah) form a small part of the overall sukuk issuances in 2105 with a total of 6% using these modes.

3. Islamic Financial Architecture: Key Components and Framework

As discussed in Chapter 1, WB and IMF (2005:5) identify pillars of financial system architecture that can promote the stability and development of the financial sector as being macro-prudential surveillance and financial stability analysis, sound financial system supervision and regulation, and financial system infrastructure. The latter includes legal infrastructure for finance, systemic liquidity infrastructure and transparency, governance and information infrastructure, payments and securities settlement systems, creditors' rights, the provision of incentives for strong risk management and good governance, credit reporting systems, etc. All the elements of the financial architecture apply to the stability and development of the Islamic financial sector.

Some of the elements of financial architecture are neutral and apply to both Islamic and conventional finance. These include sound and sustainable macroeconomic policies, effective market discipline, well-regulated payment and clearing systems, etc. However, there are certain unique features in the Islamic financial sector that may not be covered by conventional architectural institutions and require specific attention. The elements of the Islamic financial architecture that need special attention can be divided into seven categories: legal, regulations and supervision, Shariah supervision, liquidity, information and transparency, consumer protection and human capital. Specific infrastructure issues that arise due to unique features arising from Shariah compliance in each of these categories are discussed below.

3.1. Legal Infrastructure

WB and IMF (2005) identify three broad elements of the legal infrastructure for the financial sector. Firstly are the laws that set the legal and regulatory framework for the industry. The laws under this category include central banking laws, banking laws, tax laws and laws related to safety nets. The second set is the commercial laws under which banks operate. The relevant laws under these would be company law, including corporate governance law or regulations, land laws, contract laws, consumer protection laws, and creditors' rights and insolvency laws. The final element is the judicial system that involves courts and rule of law related issues. A well-functioning judicial system reduces legal risks and provides remedies to parties in case of disputes and bankruptcies.

3.1.1. Supporting Islamic Finance Laws

Laws provide the framework for establishing appropriate institutions and markets in three key financial sectors: banking, insurance and capital markets. The key laws necessary for each of these financial sectors are not only those that enable the formation and operation of financial institutions and markets but also those that enable the formation of a central bank to carry out monetary policy and establish and give authority to certain public bodies to regulate and supervise financial institutions and markets (WB and IMF 2005: 223). In many countries, the central bank plays the regulatory and supervisory roles and the central banking law authorizes it to perform these functions. The financial institutions' laws provide the legal basis to establish specific financial institutions, define their scope of operations and governance, and include issues related to the protection of different stakeholders. For example, the banking law specifies the requirements to establish a bank and defines the banking activities that these institutions can undertake. The law covers various operational issues such as governance

structure and requirements, information disclosure obligations, the protection of depositors and other stakeholders, dealing with distressed banks, etc.

The capital market law covers various aspects to ensure the smooth functioning of the securities markets. The law encompasses issues such as the conditions to issue securities to the public, their registration and trading, and regulations related to organizations dealing with the securities market such as brokers, dealers etc. Securities law reduces problems associated with raising funds from markets by clearly specifying a contracting framework for issuing securities. These laws also prevent self-dealing by instituting rules, incentives and penalties to prevent such activities. An important aspect of protecting investors is the requirement by securities law to disclose all relevant quantitative and non-quantitative information of listed companies.

Financial and real transactions may be identified differently under business law. The unique nature of Islamic financial products and organizations that are not covered by conventional financial laws necessitate the coming up with laws that can support the activities of the former. As products of Islamic banks involve dealings with real goods and services, the law has to provide for these institutions to carry out trading and investment activities. It will be difficult for Islamic banks to operate under conventional banking laws as these do not recognize the special features of Islamic banking practices. As a result, specific laws may be required to enable Islamic banks to use financial products that are based on sale, leasing and investments using risk-sharing modes. Similarly, insurance law defines the activities of the insurance business that are qualitatively different from *takaful*. One key feature of *takaful* is that the capital of the *takaful* operator is separated from the participants risk fund and the participants have certain rights that are not recognized by conventional insurance laws. While Shariah compliant stocks will fulfill certain sector wise and financial ratios criteria, the nature of sukuk is very different compared to bonds. Thus, securities laws should cater to the unique nature of Islamic securities and sukuk to not only protect the investors and stakeholders but also for the sustainable growth of the Islamic capital markets.

3.1.2. Tax regimes and impact on Islamic finance

Most economic and financial transactions have tax implications that affect costs and/or profits. Tax laws relevant to banking are related to income (profit, withholding), transactions (capital gains and stamp duties) and goods and services (value-added tax). For example, while interest paid on debt can be deducted as costs, dividends paid are considered taxable income in most jurisdictions. Similarly, withholding taxes on interest and other income such as dividends can be different so that Islamic financial instruments are taxed differently compared to their conventional counterpart.

As Islamic financial products are based on sale, leasing and partnership contracts, the tax implications can make these products more costly compared to their conventional counterparts. For example, home financing and *ijarah sukuk* may involve double stamp duties with the latter also having capital gains tax due to sale and buy-back features. Thus, there is a need to change the tax laws to level the playing field for Islamic finance with conventional finance. One way to do this is to consider the economic substance of Islamic financial products as financing tools and applying the rules of interest to profit generated in financial transactions. An example of this is in the UK where tax laws treat profit in a *mudarabah*

contract and returns payable on sukuk are treated as interest for tax purposes (PWC 2012: 102-103).

3.1.3. Dispute Settlement/Conflict Resolution Framework and Institutions

Sustainable development of any financial industry must have a suitable legal framework which includes an effective dispute resolution mechanism (Grais, Iqbal, and El-Hawary, 2004). Courts and other dispute settlement institutions ensure *ex post* implementation of contracts and enforcement of property rights in case of any breach of contracts or exercise of rights (Pistor and Xu 2003). As the contracts used in Islamic banking products are derived from the *Shariah* and the Islamic financial contracts' legitimacy should be judged by the principles of Islamic law, the ideal situation would be to use *Shariah* as the governing law to settle disputes. Thus, the dispute resolution issue becomes complicated due to the duality of laws in play in Islamic finance transactions. While the contracts use Islamic law, the courts in most jurisdictions use some variant of Western commercial law to adjudicate. This would mean using non-Islamic legal system to resolve disputes involving Islamic financial contracts. The outcome of these disputes will partly depend on the legal system and whether supporting Islamic banking law exists or not.

One way to resolve the problem of adjudicating disputes in courts using non-Islamic civil laws is to include choice-of-law and dispute settlement clauses (Vogel and Hayes, 1998). If Islamic law is chosen as the law of choice to settle disputes, the contracts can opt for commercial arbitration and be shielded from the national legal environment. While some Islamic arbitration centers exist, parties are reluctant to take disputes to these institutions due to the lack of precedence that creates legal risks. There is uncertainty regarding outcomes due to the differences of opinion among different scholars and schools and the absence of a standardized codified Islamic law. As such, partners in transactions avoid using Islamic law as they want to avoid the "impracticalities or the uncertainty of applying classical Islamic law" (Vogel and Hayes, 1998: 51).

3.1.4. Bankruptcy and Resolution of Banks

Bankruptcy law addresses defaults and restructuring by enforcing property rights of different stakeholders in an appropriate way when firms become bankrupt (Moskow 2002). Bankruptcy law along with insolvency systems entail the rules and regulations that govern access, protection, risk management, and recovery of dues by providers of debt. Insolvency systems include elements such as requiring creditor consent to file for reorganization, imposing an automatic stay on the assets of the firm on filing reorganizing, requiring secured creditors to be ranked first among distribution of proceeds resulting from the disposition of assets of the firm, and requiring the appointment of an official by the court or by the creditors to operate the firm during reorganization (La Porta *et al.* 1998). An important factor determining the rights of investors in bankruptcies is to have a sound insolvency system that has an efficient enforcement process of the claims arising from bankruptcy proceedings (World Bank 2005: 230). Inefficient bankruptcy regimes create uncertainty about creditor rights and can adversely affect the growth of the financial sector.

Certain specific issues arise in bankruptcies related to financial sector. A key factor is the quality of the collateral and the rights of the creditor on it after a bankruptcy. This is relevant in financial securities where their structure will determine the nature of risks the investors

face and how these are mitigated in case the issuer becomes insolvent. Certain specific issues arise in Islamic financial transactions due to compliance with Shariah. For example, while in an asset-backed sukuk investors have a claim on the assets underlying the issuance, an asset-based sukuk meanwhile has the investors having a claim on the issuer with no recourse to the assets. Similarly, the rights of profit-sharing investment account holders need to be clearly defined in case a bank declares bankruptcy.

3.2. Regulation and Supervision Framework

In a well-functioning financial system, the supervisors and regulators act on behalf of the society at large and protect the interests of the different stakeholders and ensure stability in the financial system as a whole (Pistor and Xu 2003). A proactive enabling regulatory and supervision framework will ensure the application of rules and laws, protection of property rights, the stability of the financial sector, consumer protection, and the fairness and efficiency of markets (see Llewellyn 2006 and GOT 2008). The complexity and dynamism of modern financial products and markets make regulation itself complex and multi-dimensional (Black 2012). If not approached correctly, inappropriate regulations can create risks and vulnerabilities that can potentially lead to harmful and costly economic downturns.

Regulatory perimeters determine the boundaries of the regulated and unregulated activities and institutions. Determining the regulatory perimeters will depend on various factors. Among others, the degree of systemic risks and customer sophistication will determine the level of regulatory intervention. The tools and goals of regulation include micro-prudential regulation to promote the safety of individual financial institutions, macro-prudential regulation and supervision for the stability of the financial sector, conduct of business regulation to establish rules for appropriate business behavior and practices, product regulation to limit specific harmful products, consumer protection regulation to protect consumers, and indirect regulation to limit exposures of institutions to certain activities and to enhance the fairness and efficiency of markets (BOE 2012; GOT 2008; Llewellyn 2006). Other regulatory functions relate to providing safety net arrangements (deposit insurance and lender of last resort) and ensuring the integrity of the payments system and markets. The regulators must also have measures in place to handle emergency situations such as handling insolvent institutions and resolving crises.

There are various models of regulatory frameworks for the financial sector. While in some countries separate bodies regulate the banking, insurance and the securities markets, in others these sectors are regulated by a single body. The GFC showed that, if legal and regulatory regimes fail to adjust to the changing situations, they become ineffective in mitigating the new risks that can lead to costly systemic problems. Furthermore, there can also be a separation of the prudential regulation and supervision from a conduct of business and consumer protection regulation under the 'twin peaks' approach (Crockett 2009: 19).

Various international bodies have come up with the various principles and standards of regulations and supervision of different segments of the financial sector. The Basel Committee for Banking Supervision (BCBS) is responsible for developing international regulatory standards for the banking sector. It came up with the Basel III standards to strengthen the regulatory regimes for the banking sector after the GFC. The new standards bolster Basel II by enhancing the quality and quantity of capital and introducing risk coverage of the systematically important financial institutions. It also enhances the supervisory review process

for risk management and capital planning at the bank level and requires higher levels of risk disclosure to improve market discipline.

IOSCO is a global multilateral organization dealing with regulatory issues related to capital markets. It published the *Objectives and Principles of Securities Regulation*, also known as the IOSCO Principles, in 1998 which were then updated in 2010 after the GFC. The document consists of 38 core principles for the regulation of the securities markets and entails three key elements: investor protection; ensuring fair, efficient and transparent markets; and the reduction of systematic risks. The key focus of the IOSCO's core objectives of securities regulation is on disclosure and transparency (Singh 2013). Similarly, IAIS (2015), an association of national level insurance regulators, has published various regulatory documents that include the *Insurance Core Principles*. Updated in 2015, the document has 28 core principles for the development of a sound and stable insurance industry.

Although the Basel regulatory principles and guidelines should apply to all banks, there are some additional regulatory requirements for Islamic financial institutions.¹¹ This stems from the use of Islamic financial contracts on both the liability and asset sides. The unique feature of *Shariah* compliance not only introduces risks to Islamic finance that are different from those of its conventional counterpart but also limits the use of certain risk mitigation instruments and products from which conventional financial institutions are able to benefit. Thus, governance and regulation of Islamic financial institutions requires a clear understanding of the risks arising in Islamic finance and then proposing appropriate measures to mitigate them. The Islamic Financial Services Board (IFSB), an international standard-setting body for the Islamic financial industry, has specified standards for Islamic financial institutions that are compatible with Basel standards.¹² IFSB is responsible for coming up with regulatory standards for all three segments of the financial sector and has published various principles, standards, disclosure requirements and guidance notes for Islamic banking, *takaful* and Islamic capital markets.

The regulatory regimes under which Islamic banks are operating can be classified into three types: Islamic, dual, and conventional. Islamic regulatory regimes are found in Iran and Sudan. The banking laws and regulatory requirements have adopted Islamic financial transactions as the only acceptable forms. The dual banking system is one in which both Islamic and conventional banking services are available. Islamic banking services are provided either by Islamic banks or through windows in conventional banks, or both. The operation of Islamic banking in a conventional regulatory regime would require the design of institutions and Islamic financial products that can operate under the existing laws and regulations. The regulatory framework of Islamic finance differs from country to country. While in some countries the same departments or units are responsible for regulating all financial institutions, in a few countries separate units exist within the regulatory bodies to deal with the Islamic financial segments of the financial sector.

¹¹ For a discussion of this, see Chapra and Khan (2000).

¹² As of April 2016, IFSB had 189 members comprising 66 regulatory and supervisory authorities, eight international inter-governmental organizations and 115 market players, professional firms and industry associations from 48 different jurisdictions.

3.3. *Shariah* Governance Framework

Shariah governance framework is an important determinant of Islamic banking practices and the types of products offered. In a survey of Islamic financial institutions, 21% of the respondents identify *Shariah* compliance issues as being among the biggest internal threats (MEGA 2016: 51). Thus, a robust *Shariah* governance regime that can ensure *Shariah* compliance in Islamic financial institutions is required. IFSB (2008) proposes four aspects that *Shariah* governance systems should entail at the level of Islamic financial institutions. These are issuance of *Shariah* pronouncements, ensuring day to day compliance with the *Shariah* pronouncements, internal *Shariah* compliance review and audit, and annual *Shariah* compliance audit to ensure that the internal *Shariah* compliance review has been properly carried out. To undertake these functions, IFSB identifies different *Shariah* organs which include an in-house *Shariah* compliance unit/department, internal *Shariah* review/audit unit and SSB.

The IFSB (2008) leaves the responsibility of *Shariah* governance at the level of organizations without any firm commitment to regulatory overview. However, to reduce *Shariah* compliance risks and ensure that the Islamic banks fulfill their fiduciary duties of conducting business according to *Shariah* principles, there may be a need for the regulatory bodies to provide *Shariah* governance frameworks and guidelines. Two broad criteria can be used to classify *Shariah* governance regimes. The first is the existence of a national framework for *Shariah* governance in the form of law/regulations supported by a complementary national *Shariah* supervision mechanism at the regulatory level. The goal of the national *Shariah* governance framework will be to accomplish the broader *Shariah* requirements of the industry and protect the interests of stakeholders not served at the organizational level. An active national *Shariah* authority (NSA) will be able to address *Shariah/fiqh* related issues, harmonize *Shariah* interpretations, and ensure compliance with *Shariah* principles. Another important area that would help reduce legal risks is the product clearance role where the NSA would identify the permissible modes of financing/investment and clear all new products coming into the market.

The second aspect of the *Shariah* regulatory framework would set up requirements to strengthen the organizational *Shariah* governance structures and processes. Other than requiring Islamic banks to have a *Shariah* Unit/Department, elements can include requirements related to various aspects of *Shariah* governance at the organizational level. The issues under regulatory purview can include the terms of reference of SSB, defining the duties and role of SSB members, approving the appointment of SSB members, specifying the qualifications and minimum number of members in the SSB, and identifying the position of the SSB in the governance structure. The code of conduct of SSB members can limit the number of banks they can serve in, maintain independence, avoid conflicts of interest, etc. The banks may also be required to have a *Shariah* compliance manual and an external *Shariah* audit. The operational issues related to *Shariah* governance would be ensuring the information disclosure of products, proper use of charity funds, and the separation of funds and risks if Islamic windows exist.

Issues related to harmonization and standardization have implications at the macro and micro levels. In the former, there is a need to harmonize the contractual stipulation of *Shariah* with the laws of the country that are based on Western legal systems to reduce friction and avoid confusion in dispute resolutions. At the micro level, the way market efficiency can be

increased is by the use of standardized contracts and documents among the financial sector stakeholders. In this regard, the regulatory authorities can facilitate coming up with standardized documents and contracts that can be used by both the financial institutions and financial markets.

3.4. Liquidity Infrastructure

To meet liquidity needs from private sources a bank must hold assets that can be sold or used as collateral to obtain credit from other financial intermediaries (Holmstrom and Tirole 1998). However, market failures may constrain access to liquidity from private sources. Opaque bank assets create information related problems where financial institutions may not be able to screen and monitor the prospective borrowers adequately (Rochet 2008). Failure of markets to provide liquidity can be resolved in two ways. Private arrangements can be used between banks to create liquidity pools. However, this is difficult to implement, particularly when the financial sector experiences economy-wide negative shocks. In such cases, public bodies such as the central bank need to provide the liquidity to prevent serious interruptions in operations that can lead to bank failures. One of the tools used by central banks is to provide emergency funding to banks as the lender of the last resort (LOLR).

3.4.1. Liquidity Markets and Instruments

While BCBS has published guidelines relating to liquidity risk management prior to the GFC, the central role of liquidity in exacerbating the crisis has led to the inclusion of specific liquidity requirements in Basel III.¹³ The objective to introducing the regulatory liquidity requirements along with the capital requirements is to promote a more resilient banking sector by improving its ability to withstand shocks from different sources (BCBS 2010). As liquidity problems faced by banks are a key feature of the crisis, Basel III has added liquidity requirement ratios in addition to reinforcing the capital requirements. Specifically, the liquidity coverage ratio (LCR) has been introduced to ensure liquidity in banks in the short term and net stable funding ratio (NSFR) has been proposed to promote medium and long-term resilience to liquidity shocks.

IFSB (2012) principles for liquidity risk management identify the following for liquidity infrastructure for Islamic finance: business laws (securities, capital markets, bankruptcy, etc.), secure and efficient payment systems, well-functioning Islamic money markets, and timely and accurate information disclosure and transparency. IFSB (2015) issued Guidance Notes on quantitative measures for measuring liquidity risk management in Islamic financial institutions and identifies issues related to LCR and NSFR. Given the short history of its development and the restrictions imposed by *Shariah* principles, the Islamic banking sector faces several restrictions that will constrain its adoption of Basel III liquidity requirements. The challenges that Islamic banks will face in meeting their liquidity needs will be identified. The chapter will also outline some key infrastructure institutions that are needed to support the Islamic financial sector at both the private and public levels.

In conventional banks, the funding of liquidity needs of banks can be met either from private sources such as other financial institutions or inter-bank money markets. As interest based

¹³ For a discussion on the BCBS guidelines on liquidity risks see Vento and La Ganga (2009).

loans are prohibited by the Shariah, Islamic banks cannot borrow funds to meet liquidity requirements. Furthermore, Islamic banks are prone to additional liquidity risks for various reasons. In most jurisdictions there is no organized Islamic money market from which funds can be sought in times of need. Second, as most assets of Islamic banks are predominantly debt-based, they are illiquid due to Shariah restrictions on the sale of debt. Thus, raising funds by selling debt-based assets is not an option that Islamic financial institutions can use.

Abdullah (2010) provides an overview of some of the liquidity management instruments used in different countries. In the UAE, the central bank launched debt based commodity *murabahah* (*tawarruq*) Islamic certificates of deposits with maturities of one week to a year. To facilitate the liquidity management of Islamic banks, the Central Bank of Bahrain started issuing short-term *salam* based *sukuk*. As *salam sukuk* are debt based and not tradable, the central bank has now moved on to issuing *ijarah* based ones which, being asset-based, are tradable. However, a lack of active secondary markets for *sukuk* can hinder their sale at appropriate prices. Malaysia is one of the few countries that has an Islamic Interbank Money Market (IIMM) in which *mudarabah* based interbank investments can be used (Abdullah 2010). Similarly, Islamic banks in Indonesia can either use the Domestic Interbank *Shariah* Financial Market operates using a *mudarabah* based Interbank Investment certificate or place their excess liquidity with the central bank under the *Wadiah* Certificate scheme.

3.4.2. Lender of the Last Resort (LOLR) Facilities

As indicated, when liquidity requirements of banks can be met at the private level, the central bank can provide the required liquidity. One of the safety-nets available to banks in emergency situations is to get emergency funds from the central bank which acts as the lender of last resort (LLOR) to protect the banking sector in such situations. Islamic banks, however, can face problems in using this facility as most of the existing LOLR facilities are interest based. IFSB (2015: 77) identifies the preconditions for developing a Shariah compliant LOLR as having a suitable legal framework for appropriate regulatory and remedial powers, coming up with a Shariah compliant model of LLOR, and having in place a robust supervisory and Shariah governance framework. A survey of IFSB of central banks of its 24 member countries carried out in 2012 shows that only six had Shariah compliant LOLR facilities (IFSB 2013: 108). The study also revealed that of the 20 countries surveyed only two had facilities of discount windows that met *Shariah* requirements and five countries had *Shariah* compliant deposit services for Islamic banks.

One of the issues related to the financial sector and economic crisis is the role of the LOLR at the international level, particularly when the liquidity required is in foreign currencies. Note that the role of LOLR at the international level is important when the whole financial sector of a country is affected by a crisis, not when an individual financial institution is in distress. There are suggestions that organizations such IMF can play the role of an international LOLR (Giannini 1999). In fact, the IMF has, to some extent, played a role in providing liquidity to countries in economic distress. However, unlike the domestic central bank, an international LOLR may not have regulatory powers (Obstfeld 2009). Another option of dealing with a liquidity crisis at the global level is to use a multilateral network of reciprocal swap arrangements between central banks of different countries (Landau 2014, Obstfeld 2009). Under this arrangement foreign currency can be swapped with domestic currency to meet to meet liquidity needs. The swaps were used by central banks such as the Federal Reserve in the aftermath of the recent GFC.

3.5. Information Infrastructure and Transparency

Information and governance infrastructure are key to financial sector development and effective market discipline (World Bank 2005: 241). The opacity of information increases risks and the costs of capital and reduce trading volumes affecting the functioning of financial markets adversely. There are two key aspects of information infrastructure that help in making sound decisions on financing and investments which in turn promote the development of the financial sector and economy. First, good quality information on financial instruments, organizations and markets must be provided to the investors and customers. Second, accurate and reliable information on credit worthiness of clients must be available to reduce risks and losses of financial institutions. These are discussed below.

3.5.1. Accounting and Auditing Framework/Transparency and Disclosure

An important element of a well-functioning financial architecture is the accounting and auditing framework that gives outside investors high-quality information. Good accounting systems producing high-quality disclosure and transparency are essential for informed decision making and promoting efficient resource allocation (World Bank 2005: 247). High quality disclosure of information and accounting practices mitigates information asymmetry and increases investor protection and enhances their confidence and the credibility of markets (Kothari 2000). The quality of disclosure depends on the quality of accounting standards and also on the institutional factors that include laws and regulations requiring compliance with disclosure standards to protect consumers.

Given the key role of a sound information infrastructure, different international bodies are encouraging the adoption of different international accounting standards to promote financial stability and economic efficiency at the national level and improve the comparability of statements between countries in an increasingly globalized world. A key component of the standards and codes initiative of the World Bank and International Monetary Fund (IMF) to strengthen the international financial architecture includes an initiative for adopting international standards (IMF and World Bank, 2005). After the recent global financial crisis, additional international bodies such as G20 and the Basel Committee Banking Supervision are also supporting the use of standards globally (Pacter, 2014). International Accounting Standards Board (IASB), an independent global standards-setting body of the IFRS Foundation, is responsible for developing accounting and reporting standards to bring about 'transparency, accountability and efficiency to financial markets around the world' to serve 'the public interest by fostering trust, growth and long-term financial stability in the global economy.'¹⁴ The resulting standards developed by IASB, the International Financial Reporting Standards (IFRS), are used by different countries to develop country level accounting standards.

Some of the accounting requirements of Islamic banking operations may not be covered by the international accounting standards (Archer and Karim, 2007; Hamid *et al.*, 1993). While some conditions in IFRS are not relevant for Islamic banks, some contractual requirements arising from Shariah compliance may not be covered in international standards. Recognizing this, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established as a standard-setting body to issue accounting and auditing standards for Islamic

¹⁴ <http://www.ifrs.org/About-us/Pages/IFRS-Foundation-and-IASB.aspx>

financial institutions in accordance with the *Shariah* (AAOIFI, 2010). Though AAOIFI uses IAS/IFRS as a basis for developing its standards when they do not contradict *Shariah* principles, it also introduces additional guidelines that are unique to the Islamic financial sector. In order to achieve fair presentation for all stakeholders, AAOIFI requires Islamic financial institutions to provide statements of compliance with its standards. IFSB has issued principles and guidelines of good corporate governance, transparency and disclosure of relevant information.¹⁵

3.5.2. Credit-Reporting Systems and Rating Agencies

A key component of information infrastructure that can promote the development of a stable financial sector is the availability of information on the credit quality of individuals, instruments and organizations. By reducing the asymmetric information problems of adverse selection and moral hazard, the availability of credit information enables the better evaluation of risks of default of different stakeholders (IMF and World Bank 2005: 257). The ratings can also be used to price different products appropriately, thereby increasing their marketability. Two broad categories of credit information institutions relevant to the financial sector can be identified. First, specialized credit rating agencies (CRAs) provide the credit ratings of large businesses, corporations and financial securities. While the ratings of securities play an important role in the proper functioning of capital markets, the ratings of corporations are used to determine the regulatory capital requirements under Basel II and Basel III. IOSCO (2003) provides the principles to guide the activities of CRAs, and IOSCO (2004) details the code of conduct for CRAs. The four key elements covered in these documents include: Quality and Integrity of the rating Process; Independence and Conflicts of Interest; Transparency and Timeliness of Rating Disclosure; and Confidential Information.

Furthermore, credit-reporting registries gather information on the credit quality of individuals and smaller firms that are not rated by the rating agencies. A sound and effective legal and regulatory framework for credit registry must strive to balance between the sharing of relevant information with the privacy and protection of consumers. WB and IMF (2005) identify the legal and regulatory framework that is needed for a sound credit reporting system to include laws on data and consumer protection and regulations on bank secrecy, consumer credit and fair credit granting.

While information produced by credit registries can be used by both conventional and Islamic financial institutions to make decisions on whether or not to finance clients and small businesses, there are some specific issues that may arise when rating Islamic financial securities such as sukuk. Furthermore, other than providing the risk attributes of these securities, there is also a need to disclose Shariah related issues inherent in these structures (Ahmed 2013). However, as most traditional CRAs may not be equipped to provide a rating in Shariah compliance due to the lack of expertise, there may be a need for a specialized organization to do the Shariah ratings. The International Islamic Rating Agency (IIRA) based in

¹⁵ The relevant standards include the following: IFSB (2007), *Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takâful) Institutions and Islamic Mutual Funds)*; IFSB (2006), *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takâful) Institutions and Islamic Mutual Funds)*; IFSB (2011), *Guidance Note on the Recognition of Ratings by external Credit Assessment Institutions (ECAIS) on Takâful and ReTakâful Undertaking*.

Bahrain is the only rating agency that rates the *Shariah* quality rating of Islamic financial institutions but has not ventured into rating Islamic securities and sukuk.

3.6. Consumer Protection Architecture

3.6.1. Consumer Protection and Financial Literacy Scheme

Since the lack of financial literacy and safeguards to protect consumers were among the factors contributing to the recent financial crisis, there has been renewed interest in a robust regulatory framework to enhance consumer protection after the recent GFC. Recognizing this, the G20, along with the OECD came up with the *G20 High-Level Principles on Financial Consumer Protection* in 2011 which identifies 10 broad principles that can enhance the protection of financial consumers. These are: legal, regulatory and supervisory framework; role of oversight bodies; equitable and fair treatment of consumers; responsible business conduct; disclosure and transparency; financial education and awareness; protection of consumer assets against fraud and misuse; protection of consumer data and privacy; complaints handling and redress; and competition (OECD 2011).

Similarly, the World Bank came up with *Good Practices for Financial Consumer Protection* in 2012 and it identifies the key features of practices to protect consumers of the banking, insurance, nonbank financial institutions, and securities sectors. The common features of consumer protection across these sectors include the following: consumer protection legal and regulatory institutions; sound disclosure and sales practices; customer account handling and maintenance; privacy and data protection; dispute resolution mechanism; guarantee and compensation scheme in times of financial distress; financial literacy and consumer empowerment; and competition (World Bank 2012). A robust consumer protection regime would also include some architectural elements such as consumer protection laws and financial education and enforcement mechanisms (Lukonga 2015). In this regard, IFSB has come up with certain guidelines that address some of the issues arising in Islamic finance.¹⁶

While most of the consumer protection issues related to the conventional finance equally apply to consumers of Islamic finance, there are certain unique issues that arise in the latter due to *Shariah* compliance. Other than architectural elements, an additional requirement for Islamic finance is to ensure *Shariah* compliance (Lukonga 2015). One of the key issues relates to ensuring the *Shariah* compliance of products and services provided to consumers by having a robust *Shariah* governance regime (Neinhaus 2015). As many customers of Islamic finance use the services with the expectation that the products comply with the *Shariah*, the regulators should ensure that this is the case. Some of the specific issues that regulators need to consider are strengthening governance protection of investments account holders, sukuk investors, and developing *Shariah* compliant deposit schemes. While the use of funds from the unrestricted IAH should be disclosed to the account holders, IFSB recommends that the IOSCO principles for Collective Investment Schemes (CIS) should be applicable for management of restricted IAHs (Lukonga 2015: 26).

¹⁶ Some of the issues related to consumer protection are outlined in IFSB (2009) *Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services* and IFSB (2008) *Guiding Principles on Governance for Islamic Collective Investment Schemes*.

One finding from empirical studies that is relevant to Islamic finance is the distinction between investors and consumers among retail clients (IFSB 2015: 96). While the retail investor interacts with the different segments of the financial sector and makes appropriate risk-return decisions, the consumer has little knowledge and experience of the financial markets. The appropriate policy for the former would be to have more disclosure and for the latter to have protection against misspelling and the improvement of their financial literacy. IFSB (2015) identifies several key instruments for protecting financial consumers. Firstly is empowering customers so that they can make better informed choices. This can be accomplished by, among other things, requiring disclosure of relevant information by financial institutions, providing consumer awareness and education programs, and having consumer advice institutions. Secondly is establishing a sound regulatory and supervisory framework that can ensure good practices and the fair treatment of financial consumers. This can be done through product and conduct regulations. Thirdly is instituting an efficient complaints handling and dispute resolution framework that addresses the concerns of clients effectively and treats consumers fairly (IFSB 2015, 96-98). Finally, there must be a deposit protection scheme for customers when financial institutions fail and close down.

Financial education programs are important tools for empowering consumers on the demand side. There is a need to introduce financial literacy schemes at different levels to reduce the information asymmetry so that consumers can make more informed decisions. Consumers who are financially literate can not only make better financial decisions but also facilitate the smooth functioning of financial markets (World Bank 2015). This is particularly true as financial products have become more complex and the risks in products are difficult to understand (Lukonga 2015: 6). Financial literacy forms an important part of the regulatory response to protect consumers in the aftermath of the GFC. World Bank (2012) considers financial literacy as a tool for consumer empowerment and protection. Although the financial regulator can take the lead in this, different government and non-government organizations should be involved in developing and implementing financial education and literacy programs by using a range of initiatives and channels such as publications, webpages, television, radio and mass-media. A sound financial education framework will target all segments of the population including schoolchildren, the youth, and the community at large. OECD (2012) came up with *OECD/INFE High-Level Principles on National Strategies for Financial Education in 2012* and *National Strategies for Financial Education in 2015*, providing a detailed framework to promote financial education globally.

While studies show that the general level of financial literacy among financial consumers is low, literacy issues for the Islamic financial sector become even more challenging as the industry is relatively new and there is a lack of awareness of its principles among the general public. Islamic financial modes of financing and products are diverse with each having their own unique features which add to their complexities. The result is that there is a low level understanding of Islamic financial products even among the educated and elite (Lukonga 2015: 27).

3.6.2. Deposit Insurance

As a part of the regulatory regime, protection of the assets of depositors when banks cease to operate is an important component of the consumer protection framework and for ensuring financial stability. Deposit insurance schemes act as a financial system safety-net when financial institutions shut down and also help prevent systemic risks (IFSB 2015: 100). Deposit

insurance schemes enhance the confidence of the clients in such cases and promote financial system stability (Calomiris and White 1994; FDIC 998). The scheme should be complemented by a sound and prudent regulatory and supervisory framework so that its use is kept to a minimum.

As the conventional deposit insurance schemes may not fulfill the Shariah principles, there is a need to have Shariah compliant deposit insurance schemes. While there is no issue to protect depositors of current account holders by using Shariah compliant deposit insurance, issues can arise to insure PSIA depositors. Contractually, PSIA deposits are mudarabah contracts that share the risks and cannot be guaranteed (IFSB 2015: 70). Restricted PSIA are treated as CIS by IFSB as they cannot be guaranteed under the scheme. The case with unrestricted PSIA, however, is more complex. As in most jurisdictions, the unrestricted PSIA are treated as deposits for capital adequacy purposes, and there are arguments for giving them the same protection as deposits of conventional banks to level the playing field between Islamic and conventional banks (IFSB 2015: 70).

3.7. Human Capital & Knowledge Development Framework

In order to be compliant with the Shariah, Islamic finance requires specific knowledge and skills on finance, Shariah and the laws of the host country. However, being a relatively new industry, there is a scarcity of qualified professionals who are proficient in these areas. There is a need for talented professionals not only at the level of financial institutions but also at the level of regulatory bodies. In a survey carried out by MEGA (2016), 63.5% of the respondents identify the availability of qualified Islamic finance staff to be limited and 18.2% indicate it to be very scarce (p. 47). In the same survey, more than half of the respondents identify developing human resources as a top priority that needs the most attention (p. 48) and 28% of the respondent identify a shortage of qualified personnel to be one of the biggest internal threats facing Islamic finance (MEGA 2016: 51).

The rapid growth in the Islamic finance industry is expected to create a huge demand for skills and knowledge in the field. A report by A.T. Kearney (UAE) Ltd in December 2006 indicated that the booming Islamic banking sector will need 30,000 jobs in the Gulf in 10 years. Another study by AlJarhi of the International Association for Islamic Economics indicated that the Islamic banking and finance industry will need about 300,000 new staff educated and trained in Islamic finance and banking. One of the key challenges that will need to be resolved is to ensure that there is enough manpower with the knowledge and skills of different aspects of Islamic finance (bankers, lawyers and Shariah scholars) to support the growth of the industry.

4. Islamic Financial Architecture: Case Studies of Selected OIC Member Countries

4.1. Bangladesh

The financial sector of Bangladesh is diversified and consists of different types of commercial banks (private, state-owned, foreign), co-operative banks, specialized development banks, merchant (investment) banks, non-bank financial institutions (investment and finance companies, leasing companies etc.), micro-credit organizations, depository participants (stock dealers, brokers etc.), insurance companies, and credit rating companies.

Since its inception in 1983, the Islamic banking industry in Bangladesh has grown rapidly and become a significant sector. At present, the Islamic banking industry is comprised of 8 full-fledged Islamic banks, 19 Islamic banking branches of 8 conventional commercial banks, and 25 Islamic banking windows of 7 conventional commercial banks, all of which provide Islamic banking services in Bangladesh. The total deposits of Islamic banks and Islamic banking branches were BDT 1417.3 billion (USD 18.25) in December 2014, constituting 20.3% of total banking deposits. The corresponding figure for credit was BDT 1195.4 (USD 15.4 billion), accounting for 22.2% of the total (BB 2015a).¹⁷ There are 77 insurance companies operating in the country and, out of those, 3 general and 8 life insurance companies are operating in line with Islamic Shariah. Out of 29 non-bank financial institutions, one NBFIs is Islamic and has operated in the country since 2001 (IFIL 2001).

Bangladesh also has a significant microfinance sector with about 700 microfinance institutions (MFIs) registered with the Microfinance Regulatory Authority (MRA) in December 2015 and another 300 MFIs being on the verge of getting licenses. With the total number of clients of the sector being 33.73 million, the total loan outstanding in the microfinance sector was around BDT 403 billion (USD 5.19 billion) with a savings of BDT 237 billion (USD 3.05 billion) as of June 2014.

The country also has two stock exchanges, namely the Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE). In 2014, the Dhaka Stock Exchange launched the Shariah Index DSES, and the Chittagong Stock Exchange Limited (CSE) launched the CSE Shariah Index (CSI) representing listed companies that are Shari'ah compliant. A total of 77 Shariah compliant companies were listed in these exchanges.¹⁸ Some Islamic mutual funds and one perpetual Islamic bond introduced by the Islami Bank Bangladesh Limited are also being traded in the market. The Ministry of Finance is actively considering issuing sukuk in a foreign currency to promote the infrastructural development of the country, but this has not materialized yet.

In its Strategic Plan 2015-2019, Bangladesh Bank outlined its vision for the financial institutions in the country. In this document, Islamic finance was mentioned twice. The first was in relation to improving their Islamic banking regulatory framework by aligning it to IFSB

¹⁷ Average exchange rates from IMF International Financial Statistics for the year 2014 are used for conversion to USD. The same source is used for converting domestic currencies to USD for all countries in this chapter.

¹⁸ <http://www.dhakatribune.com/stock-market/2014/jan/19/dse-launches-shariah-based-index-tomorrow> and http://www.cse.com.bd/pdf/cse_shariah_index_list_new.pdf

and AAOIFI standards (p. 9), and the second was related to promoting primary and secondary transactions in the Islamic bond markets by improving the trading platform and infrastructure.

4.1.2. Legal Infrastructure

Supporting Islamic Finance Laws

Different financial and banking laws and acts govern different segments of the financial sector. The Banking Companies Act, 1991 (BCA 1991) amended in 2003 governs the banking sector in the country. While no specific act on Islamic banking exists, BCA 1991 incorporates some provisions of Islamic banking. The NBFIs are governed by the Financial Institutions Act, 1993 (Act 27 of 1993) and the regulations have been made thereunder (BB 2005-06).

The insurance business in the country is undertaken under the Insurance Act 1938. The government passed two insurance laws in 2010 in a bid to further strengthen the regulatory framework and make the industry operationally vibrant. The new laws are the Insurance Act 2010 and the Insurance Development and Regulatory Authority (IDRA) Act 2010. As in the case of banking, there is no separate act for takaful operations in Bangladesh. However, the Insurance Act 2010 provides for the appointment of Shariah consultants for the proposed Insurance Development and Regulatory Authority (IDRA) to function properly. IDRA has yet to form the five-member board for the body. The Securities and Exchange Commission Act 1993 amended in 2012 governs the capital markets. While Bangladesh has securities and trust laws, currently there are no specific provisions to accommodate sukuk issuance.

In summary, no separate act or law relating to Islamic finance (banking, takaful and capital markets) exist in the country. The legal framework for the Islamic financial industry is established by some clauses or provisions that are incorporated in the existing financial acts and laws.

Tax regimes and impact on Islamic finance

Section 29 of Income Tax Ordinance, 1984 stipulates that interest and profits paid to Islamic banks can be deducted from income of businesses for tax purposes.¹⁹ The Income Tax Ordinance 1984 allows Islamic banks to deduct profits for tax purposes, but the rule of VAT is the same for both conventional and Islamic banks. Double taxation issues remain with the Islamic banks, especially in the case of a transfer of property under the ijarah contract.

Dispute Settlement/Conflict Resolution Framework and Institutions

There is no special dispute resolution framework for cases involving Islamic finance. All cases related to defaults and non-performing loans are placed under the jurisdiction of the Money Loan Court for both Islamic and conventional banks. But for a violation of the Negotiable Instruments Act 1881, the Islamic banks suit cases at the civil courts.

Bankruptcy and Resolution of Banks

The Bankruptcy Act of 1997 covers individuals and as well as companies (GOB 1997a). Additionally, the Companies Act (Bangladesh) 1994 (Act No. 18 of 1994) (GOB 1997b)

¹⁹ http://bdlaws.minlaw.gov.bd/pdf_part.php?id=672

highlights procedures for the winding-up of companies during insolvencies, and the Banking Companies Act 1991 also elaborates on dissolution and insolvency issues. Under the Bankruptcy Act (Chapter 1, Section 37), 'bank-debt' is identified as a loan given or a financing benefit in respect of which a claim may be made by a bank company as defined in the Banking Companies Act 1991 or by a financial institution as defined in the Financial Institutions Act 1993. The provisions of the Bankruptcy Act 1997 and the Companies Act 1984 apply equally for both conventional as well as Islamic banks. Thus, there are no specific insolvency laws dealing with issues for Islamic banks and takaful companies.

4.1.3. Financial System Regulation and Supervision Framework

Different segments of the financial sector are regulated by different entities. Bangladesh Bank (BB) (the central bank of the country) is responsible for regulating banks and non-bank financial institutions, Bangladesh Securities and Exchange Commission (BSEC) regulates the capital markets, the Insurance Development and Regulatory Authority (IDRA) is the regulator of the insurance sector, and the Micro-credit Regulatory Authority (MRA) acts as the regulator of microfinance institutions. The regulatory and supervisory arrangements for these entities are well defined with strong legal underpinnings. A coordination council, to enhance financial stability through improved coordination between regulators comprising Bangladesh Bank, the Bangladesh Security Exchange Commission (BSEC), the Insurance Development & Regulatory Authority (IDRA), the Registrar of Joint Stock Companies (RJSC), and the Microcredit Regulatory Authority (MRA) was established under a MOU signed among them in 2012.

The Bangladesh Bank Order (BBO) 1972 with all amendments up to 2003 defines the main functions of Bangladesh Bank (BB) which includes regulation and supervision of banking companies and financial institutions (GOB 1972). There is no specific provision or indication for BB to perform duties or take initiatives that promote the Islamic financial system or regulate and supervise Islamic financial institutions. Considering the growth and its share in the country's financial sector, BB should take various steps to facilitate Islamic banking. Bangladesh Bank issued the '*Guidelines for Islamic Banking*' in 2009 to provide a regulatory and supervisory framework for Islamic banks in the country. However, BB has not yet established the Islamic Banking Department to deal with different issues relating to Islamic finance.

BB issued a circular on 'Identifying Risk Factors Relating to Islamic Mode of Investment under Risk Based Capital Adequacy for Banks' on July 20, 2009 (BB 2009). The circular provides guidelines for management of the Capital Adequacy Framework for Islamic Banks by detailing, among other things, the capital charges for different types (credit, market and operational) of risks. It covers various risks arising in different modes of financing such as murabahah, ijarah, salam, etc. and highlights pertinent issues regarding the capital adequacy of Islamic banks.

BB has recently issued a guideline named 'Onsite Supervision Guidelines December, 2015' that also applies to Islamic banks (BB 2015c). Chapter 21 of the Guidelines deals with the supervision of Shariah based banks and conventional banks having Islamic banking branches/windows. It briefly discusses the norms and rules of supervision by recognizing the specific features of Islamic modes of finances. At the time of inspection of Islamic banks and windows of conventional banks/FIs relevant issues arising from Shariah compliance are also considered besides the general operational issues arising in conventional banks/FIs.

Bangladesh Bank became member of the Islamic Financial Services Board (IFSB) in 2002. While it is a member of the IFSB, as Bangladesh Bank regularly joins in on different meetings and its officers have work as members of guideline preparation committees, it has not taken

any steps to implement IFSB guidelines and principles for Islamic banks and Islamic non-bank financial institutions. Under Strategic Goal:2 and Objective No. 2.10 in the Second Strategic Plan (2015-2019) of Bangladesh Bank, BB has set a target to improve its Islamic Banking Regulation framework in line with IFSB and AAOIFI Standards by the year 2019 to help the Islamic banking sector (BB 2015b: 9).

The Insurance Development and Regulatory Authority (IDRA) established by the Insurance Development and Regulatory Authority (IDRA) Act 2010 replaced the office of the Chief Controller of Insurance as a regulatory body to control, guide and supervise the insurance industry in Bangladesh. While a number of takaful companies exist, the regulations for the insurance industry do not deal with the specific issues related to them. As a result, takaful companies are facing difficulties as they have to follow the conventional insurance act and regulations. For example, the regulatory requirement to invest 30% of the investable funds with government securities and bonds makes compliance difficult for takaful companies due to a lack of these instruments. While the government has issued Islamic bonds, their returns are relatively low compared to their conventional counterparts.²⁰ Furthermore, the relatively small number of Shariah-compliant companies in the stock market restricts investment opportunities and returns. Thus, takaful operators cannot operate on a level playing field with their conventional counterparts.

The Bangladesh Securities and Exchange Commission (BSEC) was established in 1993 as the regulator of the country's capital market through an enactment of the Securities and Exchange Commission Act 1993 (amended in 2012). As a statutory body attached to the Ministry of Finance, BSEC has overall responsibility to formulate and administer securities regulations. There are no specific regulatory guidelines for sukuk or Islamic securities issued by the Commission.

4.1.3. Shariah Governance Framework

Neither the financial laws nor the Bangladesh Bank Order 1972 make any provisions for BB to deal with Shariah governance issues. As a result, BB does not have an apex Shariah Supervisory Board nor does it play an active role in framing Shariah governance regimes for Islamic financial institutions. However, the Guidelines for Islamic Banking 2009 issued by BB addresses some Shariah related issues. It emphasizes promoting Shariah compliance of the Islamic financial sector by strengthening the Shariah governance framework. Other than providing advice on Shariah related issues arising in financial businesses to BB and financial institutions, Section 3 of the guidelines identifies the functions of the Shariah Supervisory Committee (SSC). The section on Responsibility for Shariah Compliance in BB (2009) make the board of directors of the respective banks responsible for ensuring that the activities of the banks and their products are Shariah compliant by forming an independent SSC with experienced and knowledgeable persons in Islamic jurisprudence. It also provides fit and proper criteria for selection of members of the SSC which include relevant educational

²⁰ While the government securities provide interest from 8% to 10% depending on the period, the Bangladesh Government Islami Investment Bond (BGIIIB) issued by the Central Bank give Islami insurance companies profits between 2% to 4% only. The investment returns of Islami insurance companies are therefore 60% to 75% less than their competitors in the conventional insurance from compulsory investment portfolio. Furthermore, the funds which are invested in Shariah-compliant Islamic bonds are reinvested by the Central Bank to Islami banks of the country, which hold excess cash liquidity and are seldom in need to buy Islami bonds. Therefore, a major portion of the fund of BGIIIB remains idle without investment. This is a real financial disadvantage for the Islami insurance companies.

qualifications, experience and exposure, track record, solvency and financial integrity, integrity, honesty and reputation.

Other than issuing the Guidelines, the role of Bangladesh Bank in controlling, guiding and supervising the Islamic Banks in Bangladesh in accordance with Islamic Shariah is minimal. No detailed Shariah governance framework exists for IFIs that include issues related to Shariah review, audit and research. However, BB has identified the basic Shariah parameters for various contracts in its Guidelines for Islamic Banking in 2009. In observing the Shariah implementation status of the Islamic banks, Bangladesh Bank examines only the report of the respective banks' Shariah Councils (Sarker 2012).

While the BB has itself not taken a proactive role in coming up with a robust Shariah governance regime, it has, in 1997, advised the Islamic banks to implement a 6-point program (BB 1997). The six-point programs were: (a) Development of an Inter-Bank Islamic Money Market; (b) Constitution of Central Shariah Supervisory Board; (c) Preparation of draft Islamic Banking Act; (d) Establishment of Islamic Insurance Company; (e) Development of New Financial Products in line with Islamic Shariah; and (f) Constitution of Consortium/Syndicate by the Islamic banks for large financing. Of the six points, Islamic banks have been able to execute two of these. The first is the inter-bank Islamic money market and the second is the establishment of a Central Shariah Board of the Islamic Banks in Bangladesh to solve any Shariah related issues.

The Central Shari'ah Board of Islamic Insurance Companies of Bangladesh has proposed a Shariah framework for the takaful industry of Bangladesh. The proposed Shariah framework allows operators to follow any of the prevailing operational models and combination of the models based on the Shariah concepts of Wakalah and Mudaraba. The rules for investment also allow takaful operators to adhere to principles and injunctions of Islam as well as to operate on a level playing field.

4.1.4. Liquidity Infrastructure

Islamic banks in Bangladesh will face excess liquidity problems as long as they cannot invest in interest-bearing government treasury bills and bonds. In the absence of limited alternatives to interest-bearing government securities, Islamic banks still experience a huge amount of surplus liquidity which remains idle in their vaults and with the Bangladesh Bank. Recognizing the problem, Bangladesh Bank has introduced two supportive measures to support liquidity management in Islamic finance. Among those, BB introduced a discriminatory statutory liquidity requirement (SLR) framework for the Islamic banks since 1983 after the inception of Islamic banking in the country. Instead of making it mandatory for Islamic banks, Bangladesh Bank has been following a discriminatory policy towards maintenance of CRR and SLR. The required ratio for maintenance of SLR, in a broad sense, by the conventional banks is fixed at 19.50% while at the same time being fixed at 11.5 percent of their total demand and time liabilities for Islamic banks.

The second initiative was the introduction of a Shariah compliant government liquidity instrument, the Bangladesh Government Islamic Investment Bond (GIIB), in 2004 (BB 2004). GIIB provides a cushion for Islamic banks to park their excess liquidity and use these as a vehicle to maintain the required amount of SLR. Effective from 1st January 2015, the GIIB has been made short-term (three months) in tenor. However, currently there are no long term Islamic bonds such as sukuk where Islamic banks can park their excess liquidity.

There are limited Islamic financial instruments and relatively inactive secondary market for trading Islamic short-term Islamic financial securities. BB issued a Guideline on Islami Interbank Fund Market (IIFM) on 27 December 2011 (BB 2011). As indicated, Islamic banks have taken the initiative to establish an interbank Islamic money market with the encouragement of BB.

BB has taken three initiatives to provide a liquidity management infrastructure for the Islamic banks. The requirement of maintaining the SLR (including CRR) still remains well below at 12.5%, compared to the requirement of the conventional banks (19%). The introduction of the Bangladesh Government Islamic Investment Bond (BGIIB) was the beginning of providing a cushion for the Islamic banks to park their excess liquidity by using it as a vehicle to maintain the required amount of SLR. There are however no Shariah compliant lenders of the last resort facilities for Islamic banks (IFSB 2014).

4.1.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency and Disclosure

The Institute of Chartered Accountants of Bangladesh (ICAB) is the national professional accounting body responsible for regulating the accounting profession in the country. Among others, ICAB issues the Bangladesh Accounting Standards (BFRS) in line with International Accounting Standards (IAS).

Bangladesh Bank Guidelines for Conducting Islamic Banking requires that licensed Islamic financial institutions should maintain proper accounting standards and prepare financial statements that can be conveniently audited. It provides the framework that Islamic banks can use to comply with the different laws of the country (BCA 1991 and Companies Act 1994), the IFRS and also the AAOIFI. While Islamic banks are required to comply with the disclosure requirements of the Securities and Exchange Rules of 1987 and the Listing regulations of the Dhaka and Chittagong Stock Exchanges, they are also required to adjust their financial statements according to the IFRS.²¹ The Guidelines, however, do not address the necessary adjustment of financial transactions that is required to comply with the requirements of the International Financial Reporting Standards (IFRS). So, reporting institutions are required to adjust their Financial Statements as per their own requirements.

Rule 12(2) of the cited Securities and Exchange Rules prescribing compliance with the International Accounting Standards (IAS) states that "The financial statements of an issuer of a listed security shall be prepared in accordance with the requirements laid down in the Schedule and in the International Accounting Standards as adopted by the Institute of Chartered Accountants of Bangladesh (ICAB)". It is also to be noted that in case the requirements of the guidelines and circulars issued by the Bangladesh Bank differ with those of other regulatory authorities and financial reporting standards, the guidelines and circulars issued by the Bangladesh Bank prevail. The Guidelines for Islamic Banking 2009 give details on the modalities of specimen reporting formats and Financial Statements for Banks operating under Islamic Shariah. It also stipulates that the BB may specify standards related to transparency and disclosure requirements that entail information that is accurate, clear, timely and not misleading.

²¹ BB (2009), Appendix II.

The Guidelines do not address all aspects of the Shariah and require Islamic banks to follow the Shariah rules set by their respective Shariah Supervisory Committee as well as those of the AAOIFI. The banks are required to disclose, among others, the types of Islamic deposits, the class of Shariah contracts used (such as Murabaha, ijarah, Mudaraba, salam, istisna'a etc), obligations to zakat payments, and income derived from Shariah non-compliant activities. Islamic banks are also required to include Shariah Committee Reports as a part of their Annual Reports, and the regulatory guidelines provide the minimum disclosure that should be included in the report.

Overall, the Guidelines on accounting issues provide the minimum disclosure requirements on Shariah related issues that should be followed by the Islamic banks. As a result a lot of information may be absent which is vital for fair disclosure. In the Bangladesh context, despite the requirement to comply with the BFRS, three Islamic banks have voluntarily opted to comply with both BFRS and AAOIFI FAS.²²

Rating Agencies

Bangladesh Bank has 8 ratings agencies licensed by the Bangladesh Securities & Exchange Commission (BSEC). In case banks have an international exposure they can also use the ratings of the international rating agencies such as Fitch, Moody and Standard & Poor. Islamic banking branches and windows of the conventional commercial banks are rated on the same basis as their conventional counterparts. Bangladesh Bank issued a guideline on the External credit rating under the "Implementation of Basel III in Bangladesh" on 21 December 2014 (BB 2014). The methodology of the rating is stated as "The capital requirement for credit risk is based on the risk assessment made by External Credit Assessment Institutions (ECAIs) recognized by BB for capital adequacy purposes". While the conventional Rating Agencies rate the Islamic banks in Bangladesh, there has been no sukuk introduced to date in the country. Of the eight ratings agencies, one (Emerging Credit Rating) has introduced ratings specifically for Islamic financial institutions.²³

4.1.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

The Consumer Rights Protection Act, 2009 (Act No. 26 of 2009) (GOB 2009) was enacted in the country to provide for the protection of the rights of consumers, prevention of anti-consumer rights practices and for the purpose of making provisions for matters connected therewith. Bangladesh Bank has taken steps to enhance Consumer Protection and Financial Literacy. The second Strategic Plan 2015-2019 of Bangladesh Bank (BB 2015b) also recognizes empowering consumers by protecting and educating consumers to be one of the key enablers of the development of the financial sector in the country. To make its financial inclusion initiatives fruitful and comprehensive, BB has strengthened the consumer empowerment

²² Al-Arafah Islamic Bank Limited stated in their financial statements that BAS/BFRS were applied 'to the extent that these do not contradict with the applicable statutory provisions and standards issued by the AAOIFI'. Islami Bank Bangladesh Limited stated in the annual balance sheet that 'its consolidated and separate financial statements had been prepared in accordance with the Bangladesh Bank Circulars, IFRS adopted as BFRS, securities law, exchange regulations and standards issued by AAOIFI, as a member of that organization'. Shahjalal Islami Bank's notes on the basis of preparation mentioned that, '...the financial statements have been prepared in accordance with the 'First Schedule (Sec-38) of the Bank Companies Act 1991 ... and ... Bangladesh Accounting Standards (BAS) and Bangladesh Financial Reporting Standard (BFRS), Standards issued by the AAOIFI and other related laws and rules applicable in Bangladesh' (AOSSG 2010).

²³ Emerging Credit Rating Limited, Bangladesh. Web: www.emergingrating.com

framework and initiated financial education programs. This is being done by adopting an action plan to 'develop comprehensive consumer protection framework through improvising existing guidelines on customer service and complaint management'.

BB has set up a dedicated department for attending consumer complaints within its own structure and issued a comprehensive 'Guidelines for Customer Services & Complaint Management in banks (BB 2014). These Guidelines are formulated with specific objectives like attaining and retaining customer satisfaction and interest protection and bank/financial institution goodwill, reputation and financial stability. The Guidelines are structured and focus on the aspects of institutional and individual ethical standards, customer service quality, customer awareness programs, and complaint management systems. The document serves the purpose of providing guidelines to all bank companies and financial institutions on customer services and complaint management systems that are expected to be in place. It sets out minimum standards that shall be expected to be achieved by complaint cells of any banking company /financial institutions.

For educating the consumers, BB has arranged an array of Cross Country Road Shows, SME Fairs, MSME credit programs and capacity building programs, Open Agri-Credit Disbursement Programs School Banking conferences in collaboration with banks. It has designed a Financial Education web portal.²⁴

Islamic Finance literacy programs are conducted by the individual banks. Islamic banks frequently arrange client awareness programs and distribute different types of Islamic product brochures. Some Islamic banks also arrange seminars and workshops at their branches. Bangladesh Bank also encourages Islamic banks to increase their financial inclusion net and take appropriate measures to increase their financial literacy program.

Deposit Insurance

Deposit Insurance Systems (DIS) was first introduced in August 1984 as a scheme in terms of "The Bank Deposit Insurance Ordinance 1984". In July 2000, the Ordinance was repealed by an Act called "The Bank Deposit Insurance Act 2000" (GOB 2000). Deposit Insurance in Bangladesh is now being administered by this Act. In 2006, Bangladesh Bank became the member of International Association of Deposit Insurers (IADI). While the direct rationale for deposit insurance is customer protection, the indirect rationale for deposit insurance is that it reduces the risk of a systemic crisis involving, for example, panic withdrawals of deposits from sound banks and the breakdown of the payments system.

A department called 'Deposit Insurance Department' (DID) has been set up at the head office of the BB to protect small depositors, enhance public confidence, enhance market discipline, enhance the stability of the financial system, ensure orderly payment systems in case of the winding up of any insured bank, increase savings, and encourage economic growth. There are two divisions in the department: Deposit Insurance Division and Liquidated Bank Monitoring Division. In case of the winding up of an insured bank, the BB is obliged to pay to every depositor an amount equal to his/her deposits not exceeding Taka 100,000. There is no Shariah compliant deposit insurance scheme for Islamic banks (IFSB 2014).

²⁴ Bangladesh Bank: An Analysis on Financial Inclusion. www.bb.org.bd

4.1.7. Human Capital & Knowledge Development Framework

Bangladesh Bank, for the first time, has devised a five year (2010-2014) strategic plan (BB 2009c) to build an efficient and dynamic financial sector capable of withstanding any shock. This is in order to produce skilled human resources for the banking sector, the central bank strengthening project of BB, Human Resources Department, Bangladesh Bank Training Academy (BBTA), The Institute of Bankers Bangladesh (IBB), Bangladesh Institute of Bank Management (BIBM) are taking measures beyond their traditional activities to produce significant change and development. BBTA and BIBM regularly conduct, among others, courses on Islamic banking and finance. The central Shariah Board for the Islamic Banks of Bangladesh also conduct different Shariah-based courses for the bankers and muraqibs. The second strategic plan (2015-2019) of Bangladesh Bank (BB 2015b) has also put a greater emphasis on the human resources development.

While professionals of Islamic banks and financial institutions can avail the training on Islamic banking and finance from BBTA and BIBM, BB has urged the apex body of Islamic banks "Islamic Banks' Consultative Forum (IBCF)" to establish an apex training institute like BIBM to cater to the research and training services needed to enhance the knowledge and skills base for the Islamic financial sector.

In the Bangladesh context, each bank has its own training institute apart from the apex training body like BIBM. The 8 Islamic banks have their own training institutes where different training courses on Islamic banking and finance are conducted. The largest Islamic bank, Islami Bank Bangladesh Limited has its definite training calendar including a referral quarterly journal named "Journal of Islamic Economics, Banking and Finance".²⁵ IBTRA also conducts a Diploma in Islamic Banking examination twice a year. IBBL always strives for excellence in improving the ethical and professional standard of its employees.

In line with the Second Strategic Plan (2015-2019), BB invests heavily in developing talent and professionalism for the financial sector by sending its employees to work both at home and abroad. The banks in the country, especially the Islamic banks, have been urged to develop their talents and professionals by modernizing their training institutes with cutting-edge knowledge and experts. The second strategy document BB (2015c) identifies the talent development to support a more dynamic financial sector to be a key enabler of the development of the financial sector in the country.

4.1.8. Summary and Conclusions

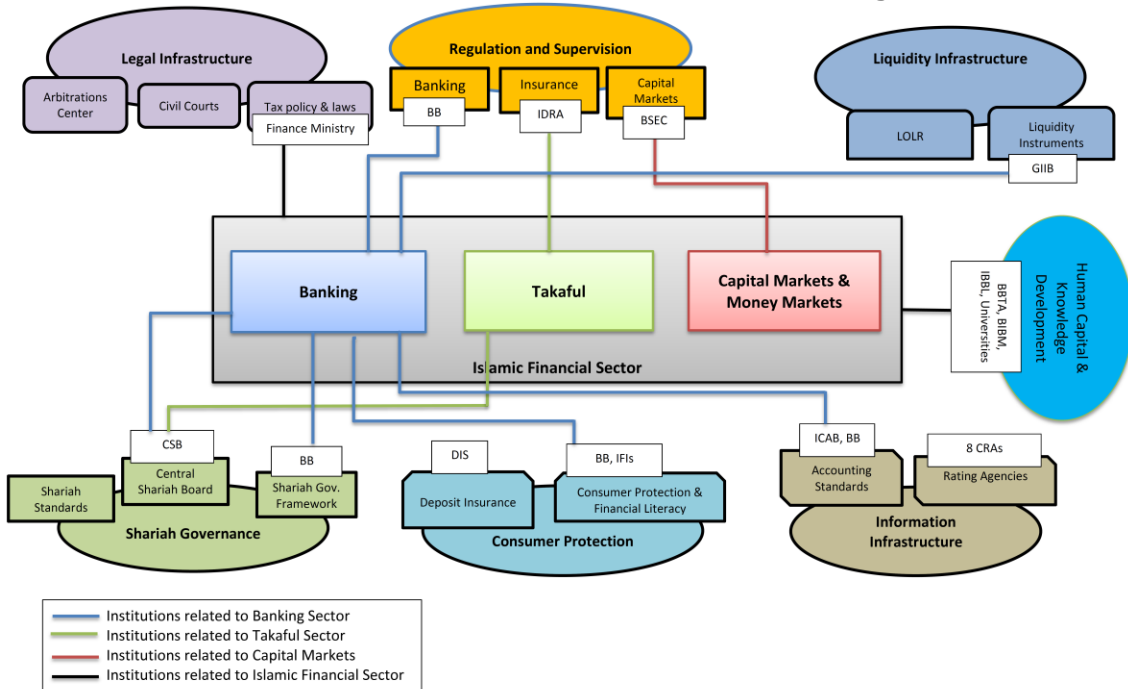
While Islamic banking has become a significant sector in Bangladesh, the developments in the takaful sector and Islamic capital markets have been relatively small. Given the significant share of Islamic banking in the country, Bangladesh Bank has taken some initiatives to support the liquidity framework for Islamic banks. While some other initiatives such as issuing *Guidelines for Islamic Banks* have been taken, the overall regulatory responses have not been proactive in general. As a result, various infrastructure institutions to support the banking industry still need to be developed.

²⁵ Islami Bank Training and Research Academy (IBTRA), training wing of Islami Bank Bangladesh Limited, website: www.ibtra.com

An interesting feature in Bangladesh is the role the industry has played in the establishment of some of the infrastructure institutions. With the encouragement and support of BB, Islamic banks have taken initiatives to establish a Central Shariah Supervisory Board and interbank Islamic money market.

There have been no initiatives to develop the legal and regulatory regime for takaful companies and Islamic capital markets. As a result, takaful companies operate at a disadvantageous level compared to their conventional counterparts. While both stock exchanges have developed Islamic indices, no sukuk have been issued. The relatively underdeveloped sukuk and Islamic capital markets also highlight the complementarity between different financial sectors whereby both Islamic banking and takaful sectors face constraints to growth due to a lack of adequate Shariah compliant liquidity and investment instruments.

Chart 4.1: Islamic Financial Architecture Institutions—Bangladesh



4.2. Egypt

The first Islamic finance experiment, MitGhamr Bank (MGB), was initiated in 1963 to provide interest-free financing to micro and small enterprises. As MGB grew in size and opened nine branches, the government decided to close it down in 1967 (Wilson 2011). Thereafter, the Nasser Social Bank was established by the government in 1971 with similar operational features to MGB (Mayer 1985). After President Sadat opened up the economy (*infitah*) for more private sector involvement in the economy, several financial institutions were established. The passage of Law No. 48 of 1977 led to the incorporation of the first privately owned Islamic bank in Egypt, Faisal Islamic Bank, which started operations in 1979 (Mayer 1985; Faisal Bank 2016).

During the regime of openness, the country witnessed the growth of Islamic finance in the 1980s with the emergence of Islamic money management companies. These institutions were considered a part of the informal sector and are not regulated by any regulatory authority (Mouawad 2009). The companies were able to attract large amounts of funds from people as they claimed to be Shariah compliant and also because of their promises of giving high returns. However, some of these organizations were structured as Ponzi schemes and collapsed in late 1980s resulting in losses to investors and damaging the reputation of Islamic finance (Wilson 2011).

Other than full-fledged Islamic banks, commercial banks can also have Islamic windows. Bank Misr was the first commercial bank to open its Islamic branch in 1980 (Mouawad 2009). Currently, Egypt has 14 banks with Islamic licenses; three banks of those are full-fledged Islamic banks (IFC 2014). The ratio of Islamic banking is estimated to be 8% of the country's total banking assets. Egypt witnessed a growing interest in Islamic banking after the GFC as reflected by the growth of assets from USD 5.1 billion in 2007 to USD 11.5 billion in 2012 and deposits from USD 4.7 billion in 2007 to USD 10.4 billion in 2012 (IFC 2014).

While the first insurance company was established around the year 1900, Egypt's first *takaful* company, Egyptian Saudi Insurance House, started operations in 2003 (Akoob 2015). The *takaful* industry has grown in Egypt with gross contributions increasing from EGP 378 million (USD 53.39 million) in the year 2009-2010 to EGP 1.202 billion (USD 169.77 million) in 2013-2014 (Noor 2015). At present, there are 8 *takaful* companies operating in the market (Nowar 2013) and the *takaful* segment accounts for 13% of the total insurance market (Akoob 2015). There are 12 Islamic funds in Egypt managed by both Islamic and conventional banks with Islamic windows. Furthermore, the first Islamic index was launched by the Egyptian Islamic Finance Association in 2013 (Tan 2015).

4.2.1. Legal Infrastructure

Supporting Islamic Finance Laws

Although Islamic finance has existed in Egypt for decades, the laws have not evolved to support the sector. The first Islamic bank, Faisal Islamic bank was established under a special law No. 48 that was passed in 1977 (IFC 2014; Faisal Bank). The regulations were silent on certain issues which allowed Islamic banks to include provisions for Shariah fulfillment in their own Articles of Association (IFC 2014). For example, article 3 of the Faisal Islamic Bank's rules states that the prohibition of *riba* and the obligation of paying *zakat* are key to its operations

(Wilson 2011). The amended Banking Law No. 88 of 2003 had no provisions for Islamic finance (Wilson 2011).

The capital markets are governed by the Capital Markets Law (Law No. 95 of 1992). The law recognizes 'bonds, financial notes and other securities' as instruments that can be listed and traded in Egyptian capital markets. There are no specific clauses on Islamic securities or sukuk in this law. Similarly, the Regulation for the Law of the Control and Supervision of Insurance and its Amendments (Law No. 10 1981, amended Law No. 91 1995 and Law No. 118 2008) governs the insurance industry. There is no mention of *takaful* in these laws.

In capital markets, a law relating to *sukuk* was passed in April 2013, but it was not implemented (Tan 2015). In January 2014, the Egyptian Financial Supervisory Authority (EFSA) announced plans to cancel the Sukuk law replacing it with a chapter in the securities law. However, in May 2014, it was reported that Sukuk law would be reconsidered again by the regulator and the Central Bank with the possibility of technical revisions put forward (IFN 2014).

Tax regimes and impact on Islamic finance

The tax regime for Islamic finance is not clearly defined in the Egyptian income tax law (Amin et. al. 2013). While there is no explicit tax law in Egypt specifically to facilitate Islamic finance, the aim of the Egyptian tax authority is to ensure that Shariah compliant financial products are taxed in a way that is equivalent to conventional banking products (Amin et. al. 2013). Thus, Islamic financial products are taxed in a way that makes them neither advantageous nor disadvantageous compared to their conventional counterparts.

Dispute Settlement/Conflict Resolution Framework and Institutions

Despite having Shariah judicial systems, the use of Islamic laws in Egypt are limited to conventional specific areas of law such as family laws, marriage and inheritance (Saleh 2011). Being commercial cases, disputes related to Islamic finance are tried in the civil courts that use the national codes and laws to adjudicate the cases.

The Cairo Regional Centre for International Commercial Arbitration (CRCICA) is the arbitration institution in Egypt for settling any conflict (Lawrence 2012). CRCICA applies the Egyptian Law of Arbitration which is based on UNCITRAL Model Law of 1985 for adjudicating the disputes. The total number of cases filed with CRCICA was 72 in 2013 and 74 in 2014 (CRCICA 2014). However, most of the disputes were not related to the financial sector with only 12% of the cases being related to lease agreements. There was no indication of dealing with cases related to Islamic finance.

Bankruptcy and Resolution of Banks

There are primarily three laws that govern bankruptcies in Egypt. The first of these is Trade Law No. 17 of 1999, the provisions of which dictate the principles and processes to follow in relation to bankruptcy. The second of these is Law No. 120 of 2009, endowing the recently created economic courts with exclusive judicial competence to adjudicate bankruptcy cases. And the third one of these is criminal law (found in the Egyptian Criminal Code), which – upon the finding of certain elements such as bad faith or fraud (or both) – allows for the filing of

criminal charges against the bankrupt entity, its directors, managers, etc. Bankruptcy processes of both conventional and Islamic banks are controlled by the Central Bank of Egypt.

4.2.2. Financial System Regulation and Supervision Framework

Law No. 88, 2003 of the Central Banking Sector and Money Law stipulate that the Central Bank of Egypt (CBE) is to be the regulator for the banking sector. The Executive Regulations of the Law promulgated in 2004 further describe the specific roles of the CBE as regulator. Among others, the Executive Regulations provide the rules for registration and operational issues related to banks. There are no specific clauses for the Islamic banking sector in either Law no. 88 or the Executive Regulations. Even though a specific law was enacted that established the Faisal Islamic bank, there were no accompanying regulatory framework for the Islamic banking sector (Simmonds, 2014). Islamic banks are treated similar to conventional banks and are required to fulfill all the same regulatory provisions such as maintaining minimum liquidity ratios and abiding by deposit protection clauses. The Central Bank of Egypt has been exploring Islamic finance in recent years but so far no new regulations have been issued.

Law 10 of 2009 established the Egyptian Financial Supervisory Authority (EFSA) replacing three major regulators (Capital Market Authority, Egyptian Insurance Supervisory Authority, and Mortgage Authority). EFSA is now responsible for regulating non-banking financial markets and instruments. Other than regulating capital markets and the insurance industry, EFSA also regulates mortgage finance, financial leasing, microfinance, pension funds, government insurance funds and factoring. The regulatory body does not have any specific regulations for the Islamic non-banking sector. However, EFSA is working on updating the current legal and regulatory regimes for the insurance industry by drafting a new insurance law and amending its regulations with a new law that is expected to have a dedicated section on *takaful* (Akoob 2015; EFSA 2016).

4.2.3. Shariah Governance Framework

There is no legal and regulatory framework for Shariah governance for the banking sector. Instead, Shariah boards at the organizational level ensure the Shariah compliance of their products and activities (Tan 2015). Although the first Islamic financial institution, MitGhamr Bank, was established in 1963, it did not refer to the Shariah except that its banking operations were aligned with the Islamic principle of not dealing with interest rates. The Faisal Islamic Bank of Egypt that began its operations in 1979 explicitly mentioned that its operations were in accordance with Shariah principles (Mouawad 2009). To ensure Shariah compliance, Islamic banks have a Shariah supervisory board that approves its products. The case with conventional banks with Islamic windows, however, is different. Some of these banks do not have either a Shariah board to verify their operations or a *zakat* account.

The Egyptian Financial Supervisory Authority (EFSA) provides guidelines for forming a Shariah board for institutions dealing with Shariah compliant capital market products (EFSA 2014). Among others, the guidelines require that Shariah scholars meet the minimum requirements in terms of experience, education and publications related to Islamic finance and economics.

4.2.4. Liquidity Infrastructure

According to law No. 88 of 2003, Islamic banks are required to maintain minimum liquidity ratios and sufficient cash to deposit ratios similar to conventional banks (Wilson 2011). Article 56 of Law 88 of 2003 defines one of the roles of the Central Bank of Egypt (CBE) to determine liquidity and reserve ratios for banks. Article 509 further elaborates on regulatory powers in term of liquidity. If any bank fails to fulfill the liquidity ratio, the CBE is required to cover the deficit and charge interest for the period the deficit occurs. Note that the law does not distinguish between the conventional and Islamic banks.

4.2.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency and Disclosure

The Ministry of Investment has the authority to issue Egyptian Accounting Standards (EAS) by taking advice from the Egyptian Society of Accounting & Auditors (ESAA) (IFRS 2013). Whereas companies in Egypt are required to follow the EAS that largely conform to IFRS, a Permanent Committee in the Central Bank of Egypt (CBE) is responsible for developing and implementing accounting and financial reporting requirements for the banking sector that are based on IAS/IFRS (World Bank 2009). Accordingly, the CBE issued new guidance on financial reporting in 2008 for the banking sector. There are no specific accounting standards for Islamic banks and CBE requires both conventional and Islamic banks to disclose and publish data according to their specific standards. These rules obligate all banks to be transparent and clear about their operations.

Rating Agencies

The Middle East Rating & Investors Service (MERIS) was established in Egypt in 2003 as a joint venture of Moody's Investors Services and FinBi (Finance and Banking Consultants International) (MERIS 2015). MERIS is considered a platform for providing credit rating analysis and research not just in Egypt but also in other countries in the Middle East. MERIS provides ratings of corporations, financial institutions and structured finance products. Rating is mandatory for issuing bonds in Egypt. While there are no specific ratings structures for sukuk, MERIS provides ratings of asset-backed securities arising from conventional transactions under its structured finance products (MERIS 2015).

4.2.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

Law No. 67 of 2006, the Consumer Protection Law forms the basis for protecting consumers of all goods and services in the country. Article 12 of the law stipulates the creation of a Consumer Protection Agency as an independent public legal entity that will be responsible for ensuring the protection of consumers' rights. Article 17 authorizes the Agency to establish a Dispute Settlement Committee that will settle disputes arising between consumers and suppliers.

For consumer grievances in the banking sector, the Complaints Department at the Central Bank of Egypt receives complaints against banks that can be communicated by different means

such as mail, email or fax (CBE 2016). The complaints are conveyed to the concerned banks and the department follows up to ensure their resolution. Similarly, one of the roles of the Egyptian Financial Supervisory Authority is to ensure that the rights of investors and clients of the nonbanking financial sector are protected. In line with Article 48 of the Executive Regulation of Supervision and Control of Insurance Law (Law No. 10, 1981), a standing committee established Decision No. 120 2009 with the goal of settling disputes in the insurance, mortgage finance and leasing industries (EFSA 2016b). Specifically, in case of insurance the committee deals with the insurer or beneficiary when compensation is not paid according to the terms of the policy. The rulings of the committee are not binding and the parties have the right to take the dispute to the court.

The Egyptian Banking Institute (EBI) of the Central Bank of Egypt has taken the lead in promoting financial literacy in the country among various target groups such as schools and university students and SMEs (EBI 2016b). EBI has partnered with international organizations to produce outreach financial education programs (EBI 2016a). For example, EBI became a new member in the OECD International Network on Financial Education (INFE) in order to protect the Egyptian consumers (EBI 2016b). The main goal of this joint venture is to strengthen and spread knowledge related to financial literacy in Egypt through understanding banking and financial markets. The financial education activities include, among others, awareness sessions at universities, interactive financial education sessions at schools, children and youth group visits to banks, financial education days, etc. EBI launched series of radio talk shows on financial literacy awareness and education and also held financial literacy workshops to help develop the financial education strategy (CYFI 2014). There are no separate awareness literacy programs for Islamic finance.

Deposit Insurance

The Central Bank of Egypt established rules to supervise and secure deposits in both conventional and Islamic banks as in Law No.88 of 2003. Article 87 of the law maintains the establishment of a Deposit Insurance Fund (DIF) at the Central Bank of Egypt as a separate legal entity with its own board of trustees and independent budget. The articles of association of the deposit insurance scheme would identify the governance of the Fund and includes issues such as membership fees, scope and limit of insurance, auditing system, etc. There is no specific program for deposit insurance for Islamic banks.

4.2.7. Human Capital & Knowledge Development Framework

The Egyptian Banking Institute (EBI), an affiliate of the Central Bank of Egypt, offers programs, workshops and training to help and develop the human capital in the financial sector. It has more than 60 training programs in both the Arabic and English languages. Moreover, it cooperates with the best international institutions such as Development Dimensions International and Financial Technology Transfer Agency to provide the training. CBI's banking and finance training packages include a course on Islamic Banking.

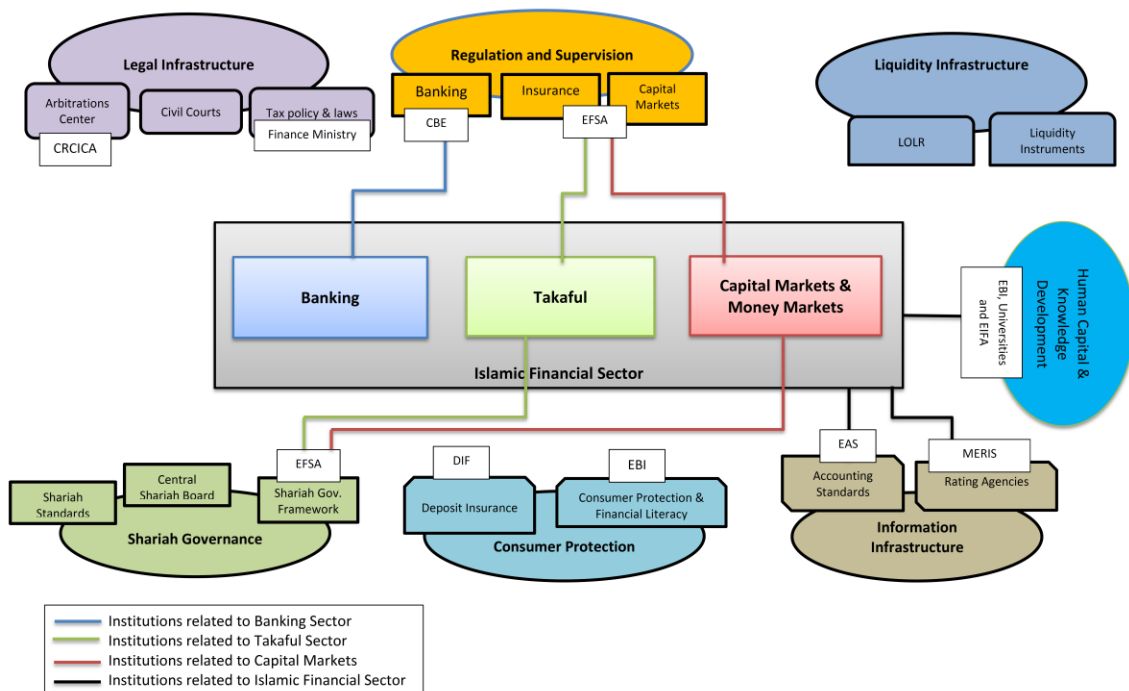
Egyptian Islamic Finance Association (EIFA) offers Islamic finance courses as well as Islamic finance programs for Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) certificates. B&F-CIPA offers a certified Islamic Professional Accountant program. Moreover, Al-Azhar University has an Islamic Economics and Finance Center and some other universities such as the American University in Cairo, Nile University and the British University

offer a few courses on Islamic finance.

4.2.8. Summary and Conclusions

The status of financial architecture for Islamic finance in Egypt is summarized in Chart 4.2. Even though modern Islamic finance has its origins in Egypt, the infrastructural institutions to support the industry have not developed. Specifically the laws and regulations related to different segments of Islamic financial industry are not reformed adequately to accommodate and promote Islamic banking, takaful and capital markets. Similarly, no substantial adjustments were made in other supporting infrastructure institutions such as Shariah governance framework, liquidity and information infrastructures and consumer protection and financial literacy. Egypt, however, has contributed to the development of human capital and talent for Islamic finance both in regulatory bodies and also at academic institutions.

Chart 4.2: Islamic Financial Architecture Institutions—Egypt



4.3. Indonesia

Indonesia has a diversified financial sector with banks, insurance, nonbank financial institutions (NBFIs) and capital market segments. Islamic finance was initiated with the establishment of the Islamic cooperative *Koperasi Jasa Keahlian Teknosa* in 1980 in Masjid Salman of the Bandung Institute of Technology (ITB), West Java Province. Thereafter, the first fully-fledged Islamic bank, *Bank Muamalat Indonesia* (BMI) was formed in 1991 followed by *Bank Syariah Mandiri* (BSM), owned by Bank Mandiri in 1999. Currently, the country has 12 fully fledged Islamic banks (BUS), 22 Islamic banking windows (UUS), and 163 Islamic rural banks (BPRS) holding total assets of nearly USD30 billion (nearly 5% market share) (OJK, 2016).

Indonesia has a robust nonbank financial sector. The insurance/*takaful* sector has 52 Islamic insurance/*takaful* companies with assets totalling USD2.4 billion (5% market share). Other Islamic NBFIs include more than 5000 Baitul Maal wat Tamwiil (BMT) operating mostly in 73,067 villages with total assets of at least USD0.5 billion, one state owned pawnshop company, and 26 Islamic securities companies offering 85 Islamic securities products valued at USD1.1 billion (4% market share) (OJK, 2016).

Islamic financial markets in the country include stock, money and sukuk market segments. The Islamic stock market was introduced in 2000 and currently enlists 334 Islamic stocks (constituting 40% of the total stocks) with total transactions of USD262 billion (55% of the total stock market transactions) (OJK, 2016). Various Islamic money market instruments were introduced in the country with total range of transactions in money market being between USD60 million and USD130 million per day (Bank Indonesia, 2016a). The *Sukuk* market has 41 corporate *Sukuk* (10% of the total bonds) with transaction values of USD0.8 billion and 32 government *Sukuk* (25% of the total bonds) with transaction values of USD27 billion (Ministry of Finance, 2015). Data from January 2016 show that that total value of Indonesian Global Sukuk (SNI) has reached USD7 billion making it the largest issuer of the global Sukuk issuance in the world (Ministry of Finance, 2016).

Various government agencies have taken different initiatives to foster the development of the Islamic financial sector. Bank Indonesia (the central bank) released a blue print of Islamic banking development in 2002-2012, identifying some pillars such as institutional development, regulation and supervision, and education and familiarization of Islamic banking practices (Bank Indonesia, 2002). After the regulatory role of the financial sector was transferred to the newly established Indonesian Financial Services Authority (OJK) in 2011, it released three strategic documents for different financial sectors: a road map of the Islamic banking industry (2015-2019), a road map of the Islamic capital market (2015-2019), and a road map of the nonbank Islamic financial institutions (2015-2019) (OJK, 2015). Bank Indonesia is responsible for the monetary aspect, money market and macroprudential policy (Bank Indonesia, 2016b). Hence, in addition to the roles of the OJK to improve Islamic finance, Bank Indonesia has the legal capacity to conduct the Islamic monetary policy, regulate the Islamic money markets and determine the macroprudential policies for both the Islamic and conventional banks.

To speed up the development of Islamic finance, the President of Indonesia formally declared the formation of the National Islamic Finance Committee (KNKS) in January 2016. As a national champion body, KNKS consists of 10 economic and regulatory bodies that include Bank

Indonesia, OJK, Indonesian Deposit Insurance Corporation (LPS), Ministry of Finance, National Sharia Board (DSN), State Ministry of National Development Planning (Bappenas), Ministry of Religion, Ministry of State Owned Enterprise, Ministry of Cooperatives and Small and Medium Enterprise, and Ministry of Economic Coordination. Finally, the KNKS will be responsible to integrate and coordinate comprehensive policies on Islamic economics and finance at the national level.

4.3.1. Legal Infrastructure

Supporting Islamic Finance Laws

The legal foundation of Islamic finance was laid out in 1992 with the passage of the Banking Act Number 7, 1992 by the parliament that enabled the implementation of dual (conventional and Islamic) banking systems. The act endorsed the unique operations of Islamic banking by clearly mentioning “profit sharing” banks. This legal infrastructure continued to develop with the amendment of the banking act of 1992 with Act Number 10, 1998 that allowed the conversion of conventional banks to Islamic and also permitting conventional banks to establish Islamic banking units (UUS). The legal framework of Islamic banking was further strengthened by Islamic Banking Act Number 21, 2008 which provided a comprehensive legal basis to support the growth of the Islamic banking industry and also reflected the strong political will of the government and regulators to support Islamic finance. The Insurance Act Number 40 2014 governs the whole insurance industry. As there is no specific law concerning *takaful*, the sector is regulated similar to the conventional one using the provisions of the articles of the Insurance Act.

While a state owned communication company (Indosat) issued a *mudarabah*-based corporate *sukuk* to finance its project in 2002, the legal foundations for *sukuk* instruments, market and transactions were laid with *Sukuk* Act Number 19, 2008. Thereafter, the government issued the first Islamic Fixed Rate (IFR) *Sukuk* in the domestic market in 2008 that was followed by a Retail *Sukuk* (SR), Indonesian National *Sukuk* (SNI), or Indonesian global *Sukuk* and Pilgrimage *Sukuk* in 2009. The Islamic Treasury Notes (SPN-S) were issued in 2011 and finally a Project Based *Sukuk* (PBS) was issued in 2012 (Ministry of Finance, 2015). More recently, Garuda Indonesia, another state owned company successfully issued its global *Sukuk* in 2015 and raised at least USD2 billion funds from the market.

Besides the Islamic banking and *sukuk* acts, the Central Bank Act Number 23, 1999 formally permits the application of the Islamic monetary policy, Islamic monetary operations and Islamic monetary instruments. Accordingly, Bank Indonesia, the central bank of the country, has issued Bank Indonesia Islamic Certificate (SBIS) (Bank Indonesia, 2008a) and Bank Indonesia Islamic Funding Facilities (FASBIS) (Bank Indonesia, 2009) as its Islamic monetary instruments.

As indicated, Indonesia has a diversified financial sector with a large microfinance industry component. The Microfinance Act Number 20, 2008 and Microfinance Institution Act Number 1, 2013 were enacted to strengthen the microfinance sector and are applicable to both conventional and Islamic microfinance institutions. These acts provide microfinance businesses a strong legal foundation to operate and function as financing providers serving micro and small business entities. In particular, they specify the criteria, activities, principles

and values of microfinance, purposes and fund management, guarantee scheme and development program for both conventional and Islamic schemes.

Tax Regimes and Impact on Islamic Finance

The Ministry of Finance contributed to the development of Islamic finance by amending the tax regulation and issuing Value Added Tax Act Number 42, 2009 to accommodate tax treatment for Islamic financial transactions. Referring to this act, the government adopts a pass-through tax treatment for Islamic finance contracts. Income Tax Act Number 36, 2008 included Islamic businesses as one of the income tax objects. Following up on these acts, the Finance Ministry released the Ministry of Finance Regulation Number 136/PMK.03/2011 on income tax for any Islamic business. The regulations determine that: (i) tax for the commercial leasing based on *Ijarah* contract is treated similarly as the commercial leasing without optional right and, (ii) tax for the commercial leasing based on *Ijarah muntahiyah bittamlik* is treated similarly as the commercial leasing with optional right.

Furthermore, the tax laws stipulate that any profit arising from Islamic financial contracts becomes an object of the income tax in similar way to how interest is treated in conventional contracts. Similarly, Ministry of Finance regulation number 137/PMK.03/2011 on income tax for Islamic banking businesses consider Islamic bank incomes as objects of the income tax in the same way the law of income tax applies to interest-based (conventional) contracts.

The tax laws also deals with double taxation issues arising in Islamic financial contracts. Particularly, an asset transfer is treated as the one from the owner of asset to the buyer (Islamic bank client) and is taxed once only. With this tax treatment, the issue of double stamp duties is resolved in Islamic trade based financial contracts that are used in banks, nonbanks and even financial markets.

Dispute Settlement and Conflict Resolution Framework and Institutions

Other than using the civil courts that use the laws of the countries for adjudicating disputes in Islamic finance, disputes can also be taken to the religious court body that also deals with the Islamic banking industry. Indonesia enacted Religion Court Act Number 3, 2006 to facilitate dispute settlement of cases arising in Islamic financial transactions. This act gives the parties the right to take any dispute in Islamic finance to be adjudicated either in religious court or national civil courts. The Article 49 of the Act extends the responsibilities and authorities of the religion court body to cover investigation, court decision and settlement of the disputes in humanities, charities (*awqaf*, *zakah*, etc) as well as the Islamic economy. The Islamic economy is defined broadly as activities or business operations based on Sharia (Islamic) principles, and this includes Islamic banks, Islamic microfinance, Islamic insurance (*takaful*), Islamic reinsurance, Islamic mutual funds, *Sukuk* and other medium to long term Islamic securities, Islamic financing, Islamic pawnshop, Islamic pension funds and other Islamic businesses.

The mandate of the Religious Court body was legalized further in Article 55 of the Islamic Banking Act number 21, 2008 that maintains that the court body can mediate and settle the Islamic financial transaction disputes. However, this law also allows for settlement outside the religious court body as long as it is agreed upon by the parties of the contract. The avenues for resolving disputes include consensus (*musyawarah*) among parties through banking mediation in the OJK, National Islamic Arbitrage Body (Basyarnas), or even in the general court.

Bankruptcy and Resolution of Banks

The Financial Stability Coordination Forum (FKSSK) chaired by the Minister of Finance and its members (governors of the Bank Indonesia and Chairman of the Indonesian Deposit Insurance Corporation) deals with issues related to bank failure, bankruptcy and systemic financial system instability. The goal of FKSSK is not only to maintain financial stability but also to anticipate and prevent instability in the banking system by avoiding bank failure and bankruptcy (Republic of Indonesia, 2011).

Regulation of bankruptcy and bank failure are stipulated in the Indonesian Deposit Insurance Corporation (LPS) Regulation Number 2/PLPS/2011, 2011. It defines bank failure as a bank having financial difficulty which endangers its business operations and cannot be solved by the banking supervisory authorities (Bank Indonesia or other regulators). One way to resolve the issue is with the placement of LPS's private funds in the failed bank to improve the financial conditions of the bank temporarily. Another way of resolving bank failure by the LPS is to sell the stocks of the failed bank to the public either via direct selling to potential investors or via the capital market. Stocks can be offered to either individual investors (domestic or overseas) or institutional investors (domestic or overseas).

4.3.2. Financial System Regulation and Supervision Framework

Regulations on the Indonesian financial system both conventional and Islamic financial systems are under the purview of Bank Indonesia (BI), the Indonesian Financial Service Authority (OJK), the Ministry of Finance, and the Indonesian Deposit Insurance Corporation (LPS). In 2011, the regulatory role of Islamic banking was transferred to the newly established Indonesian Financial Services Authority (OJK) (under Act Number 21 year 2011 on OJK) which became the regulatory authority for both conventional and Islamic banking, nonbank financial institutions, and capital markets. While Bank Indonesia is responsible for the monetary system (monetary authority), macroprudential policy, money market, payment system and financial system stability, OJK is responsible for microprudential policies and the regulation/supervision of the banking system, capital market, and nonbank financial institutions (Republic of Indonesia, 1999 and 2004).

As indicated, the Ministry of Finance acts as a fiscal authority to manage tax, state budget, regional financial system, etc, and the Indonesian Deposit Insurance Corporation is a deposit guarantor that deals with bank failure (Ministry of Finance 2015 and Republic of Indonesia, 2004).

For banking supervision, the main actor is the OJK which regulates and supervises both Islamic and conventional banks. OJK conducts both on-site and off-site banking supervisions with a risk-based banking supervision mechanism. However, in certain cases, if the bank is in financial difficulty or even default, OJK will coordinate with Bank Indonesia to determine its potential systemic risk impact, with the LPS to plan for the bank's failure mitigation, and with the Ministry of Finance as a representative of the government to get a final recommendation on the status of the bank.

Currently, financial regulators are in discussion with the parliament to issue the Financial System Security Network (JPSK) Act that will identify the responsible party (body or regulator) to make decisions on bank failure, financial system distress, and even financial/economic

crises in the country. The act will legally support the functions of the Financial Stability Coordination Forum (FKSSK) to maintain financial system stability in the country.

4.3.3. Sharia Governance Framework

Indonesia has an independent central Sharia regulatory authority called the National Sharia Board (DSN) that deals with, among others, issuing verdicts (fatwa) related to Islamic economics and business. DSN, a subsidiary of the National Ulama Council (MUI), was established in 1999 with issuance of the MUI Decree Number Kep-754/MUI/II/1999 (DSN, 2015). Some unique features of the DSN include that (i) it is not under the purview of Ministry of Finance or the Central Bank, (ii) it consists of representative members from all Islamic organizations (mainly Muhammadiyah and Nadhatul Ulama), (iii) the Sharia decisions are decided based on a consensus of all representative scholars of DSN, and (iv) the DSN's operational budget does not come from financial industries or market players.

DSN has issued close to 100 verdicts covering the banking sector, capital markets, money markets and nonbanking sector as well as social sectors. Being an independent body, DSN verdicts are considered conservative as it has not allowed the implementation of certain Islamic financial contracts such as *bay al innah*, *tawarruq*, *bay al dayn*, *bay al wafa*, etc. The governance of Sharia approval follows certain set procedures. Before submission of a new product/instrument to the regulators for approval, the Sharia Supervisory Board (SSB) of financial institutions should get it cleared by the DSN. If the DSN approves the product then it is forwarded to the regulators (OJK and BI) who examine the product/instrument proposal from the economic and financial systems' points of view.

Along with the DSN activities and decisions, Article 32 of the Islamic Banking Act 2008 mandates Islamic financial institutions to have SSB deal with Sharia issues in banking operations.

4.3.4. Liquidity Infrastructure

Various liquidity management instruments can be used by the Islamic financial sector in Indonesia. First, the central bank serves the market with Islamic liquid instruments to solve liquidity problems. These instruments include Bank Indonesia Islamic Certificate (SBIS) and Bank Indonesia Islamic Funding Facilities (FASBIS), repurchase (repo) of SBIS to Bank Indonesia, Repo of the Government *Sukuk* (SBSN) to Bank Indonesia, reverse repo of the SBSN to Bank Indonesia and Islamic Foreign Exchange Deposit in Bank Indonesia (Term Deposit Valas). In case urgent liquidity is needed, there are the Islamic Intraday Emergency Liquidity Facility (FLIS) (Bank Indonesia, 2005) and Islamic Short Term Financing Facility (FPJPS) (Bank Indonesia, 2008b) as the lender of the last resort (LOLR) instruments with Islamic schemes (Bank Indonesia, 2015b)

While the market players (Islamic banks or conventional banks) mainly use Interbank *Mudarabah* Investment Certificate (SIMA) in the Islamic money market (PUAS), their transactions are small as most of the Islamic banks' liquidity extends to finance the real sector (Bank Indonesia, 2015). The funds placed in PUAS are purely for dealing with short term liquidity needs. The Islamic money market instruments include SIMA (Bank Indonesia, 2007), Interbank Islamic Commodity Trading Certificate (SIKA), and Islamic repurchase (Repo) (Bank Indonesia, 2012). In addition to the Islamic money markets, market players can also invest in

both Repo of the Government *Sukuk* (SBSN) and corporate *Sukuk* which are instruments available for repo Sharia, a new BI regulation to allow banks to do interbank *sukuk* trading for liquidity purposes using the repo mechanism.

4.3.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency And Disclosure

In line with article 35 of the Islamic banking act (Republic Indonesia, 2008a) that stipulates Islamic financial institutions must use accounting standards reflecting Shariah features, the Indonesian Accounting Association (IAI) released a guiding framework for accounting and reporting Islamic financial transactions in 2010. In addition, IAI has developed Islamic accounting standards for various Islamic finance transactions under regular accounting rules, namely the Financial Accounting Standard (PSAK). Examples of these accounting standards for Islamic finance include the following (IAI, 2015):

- PSAK 101 for Islamic financial reporting standard, replacing PSAK 59 for Islamic banking accounting standard.
- PSAK 102 for Murabahah accounting standard.
- PSAK 103 for Salam accounting standard.
- PSAK 104 for Istishna accounting standard.
- PSAK 105 for Mudarabah accounting standard.
- PSAK 106 for Musharakah accounting standard.

PSAK 101 (released in 2008) on transparency and disclosure requires all Islamic entities to disclose information on assets, liabilities, temporary syirkah (join venture) funds, equity, income and cost as well as profit/loss, cash flow and charity funds.

Rating Agency

The Islamic financial institutions are rated internally in the OJK while, externally, Islamic securities are rated by two central bank approved rating agencies, namely PT. ICRA Indonesia and PT. Pemeringkat Efek Indonesia (Pefindo). Initiated by Bank Indonesia and Bappepam (capital market authority) in 1993, Pefindo is locally-owned domestic credit rating agency. As of December 2014, Pefindo was owned by a total of 86 entities representing key players from Indonesian capital markets with no shareholder owning more than 50 percent (Pefindo, 2016). The agency has rated 500 companies and regional governments including their financial market instruments, both conventional and Islamic.

4.3.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

Article 30, OJK Act 2011 stipulates that the regulator OJK has to enforce certain rules to protect consumers and the public in relation to financial transactions. Specific issues that are addressed include requiring financial institutions to have systems to address consumer complaints and instituting financial compensation from the prejudiced party to cover consumer losses. In line with the OJK, the central bank takes a role in protecting consumers in the payment system. Particularly, article 3 of the Bank Indonesia Regulation Number 16/1/PBI/2014 declares BI protections on consumer fairness, transparency, consumer data and information and, solving consumer complaints in dealing with the payment system (Bank Indonesia, 2014). Moreover, BI and OJK have integrated and coordinated financially literacy programs for the public called “Let’s save in banks” (lakupandai). Furthermore, Bank Indonesia, specifically, applies a financial inclusion program to bring financial institution services to all people. The consumer protection framework is common for both conventional and Islamic financial sectors.

Deposit Insurance

The Indonesian Deposit Insurance Corporation (LPS) is the only deposit guarantor for banks in the country. According to LPS Act Number 24, 2004 (Republic of Indonesia, 2004a) and government regulation related to the LPS Act, the LPS is mandated to be the guarantor of depositor funds in banks and to maintain banking system stability. Accordingly, LPS determines deposit guarantee policies, arranges deposit guarantees, and also deals with the resolution of failing banks (article 4 and 5). Given its mandate, LPS collects bank insurance premiums, collects data and information on banks (balance sheet, depositors funds, etc.), pays the claims, and resolves the failing bank (article 6). As such, all banks in Indonesia are objects of the depositor guarantee mechanism through LPS. Each bank needs to pay LPS a contribution and insurance premium (two times a year) and must give the required bank documents, data and information to LPS (article 12). While all banks in the country are required to be a part of the deposit insurance scheme, there is no specific program for Islamic banks.

4.3.7. Human Capital and Knowledge Development Framework

There are at least three nationwide and independent nonprofit organizations that are fully dedicated to accelerating the development of Islamic finance and improve the quality of Islamic human capital. Firstly, the Islamic Economic Society (MES), was established in 2001 has with the goal of educating and familiarizing people with Islamic finance (MES, 2015). MES has hundreds of executive board members with high profile professionals that include the Chairman of the regulatory body OJK as the current head, the Governing Board chaired by the Chairman of the National Ulama Council (MUI), and the Board of Experts headed by a former Minister of state owned enterprises. MES has 28 committees covering awqaf, human development, public education, takaful, technology, etc. Financially supported by industry players (banking, nonbanks and social institutions), MES organizes many seminars, conferences, public hearings, and discussions on Islamic finance, economics and banking.

Secondly, the Indonesian Islamic Economics Experts (IAEI), established in 2004, is chaired by the current Minister of Finance and the former Director General of IRTI-IDB (IAEI, 2015).

Similar to MES, IAEI has hundreds of executive members, particularly lecturers, researchers and academics from all provinces in Indonesia and even from overseas such as Bahrain, Malaysia and England. Its Board of advisors is chaired by the former President of Indonesia and has a governing board headed by the Chairman of the National Ulama Council (MUI). It also has 26 departments that include Islamic economic education, research and publication, socialization, etc. The activities of the IAEI focus on human capital development and research which includes publishing IAEI journals on Islamic economics and banking; hosting an Islamic finance and economic research forum; holding competitions on Islamic economics and finance research papers; developing Islamic economics and banking curriculum for senior high school and universities; and standardizing Islamic finance knowledge and skills among lecturers, Islamic bankers, researchers, etc. by offering an Islamic economic and finance standard certificate.

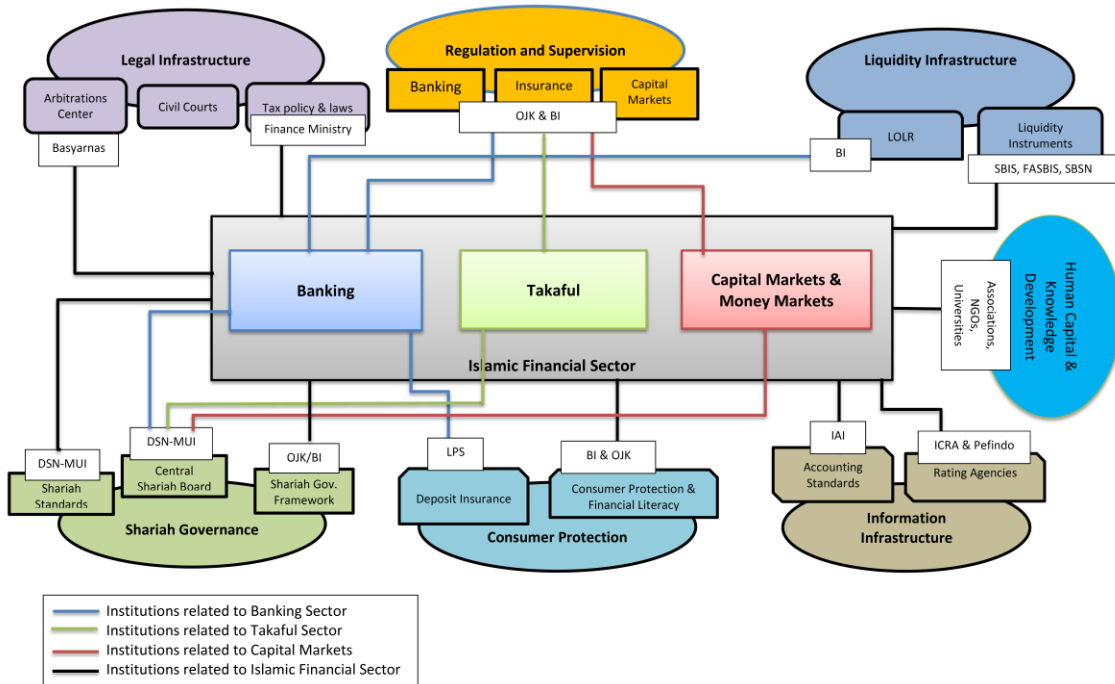
Thirdly, the Islamic Economic Communication Center (PKES) was established in 2003 and is headed by the Chairman of the Indonesian Deposit Insurance Corporation (LPS) and the former deputy governor of Bank Indonesia (PKES, 2015). PKES is positioned to be the center for any communication, coordination and collaboration among stakeholders in relation to Islamic economic banking and finance. It integrates a website of Islamic economics, mailing lists and various media (bulletin, news, etc.) as well as coordinates a nationwide program called the Islamic Economic Movement (GRES).

Besides, three leading nonprofit organizations, undergraduate students formed a nationwide organization called the Gathering of Islamic Economics Studies (FOSSEI) in 2001. It has 7000 undergraduate student members coming from 157 universities in the country. It not only has regular discussions and national research forums on Islamic economics, banking and finance but also has programs to educate undergraduate students with Islamic finance, namely Islamic economic campaign and training for trainers.

4.3.8. Summary and Conclusions

Though starting relatively, late Indonesia appears to have developed the key infrastructure institutions for the Islamic financial sector. The country has changed financial laws to accommodate all Islamic financial sectors and the finance ministry has changed tax laws to ensure tax neutrality. The latter eliminates the tax burden disparity and levels the playing field with conventional finance. Furthermore, a specific arbitration center exists where disputes related to Islamic finance can be adjudicated. The regulatory authorities have not only adopted regulations related to Islamic financial sectors but have also come up with strategic documents to further develop the industry. The Shariah governance regime for the Islamic finance industry is robust with a national level independent Shariah authority that issues the Shariah rulings and which the regulators provide a framework for Shariah governance at the level of financial institutions. Indonesia has developed various liquidity management instruments and the central bank has LOLR facilities for Islamic banks. The domestic accounting body has come up with accounting guidelines for Islamic finance and the ratings agencies have the capability to rate Islamic financial institutions and instruments. The consumer protection regime is also sound with specific schemes for Islamic finance related to financial literacy and deposit insurance. The country has many academic institutions at the public, private and nonprofit levels that are engaged in research and education in Islamic finance.

Chart 4.3: Islamic Financial Architecture Institutions—Indonesia



4.4. Malaysia

One of the first Islamic nonbank financial institutions, the Pilgrims Management and Fund Board (Lembaga Tabung Haji), was established in Malaysia in 1969. Thereafter, the first Islamic bank was launched in 1983 and a *takaful* company was initiated in 1984. The Islamic financial sector has grown rapidly in Malaysia to become a significant and robust component of the overall financial sector. With 76 Islamic financial institutions and an estimated value of USD 423.3 billion in 2013, the country is a global leader in Islamic finance accounting with 25.5% of the total global Islamic financial assets (IRTI and TR 2015: 5). The Islamic banking assets in the country are worth USD170.28 billion, constituting 21% of the overall banking sector, and the *takaful* assets were worth USD 8.596 billion accounting for 10% of the insurance industry (CIBAFI et. al. 2015: 5, 10). The size of the capital market in Malaysia in 2013 was RM 2.733 trillion (USD 810 billion), of which 56.4% was *Shariah* compliant. The Islamic equity market was worth RM 1.029 trillion and the *sukuk* market constituted RM 512.1 billion (CIBAFI et. al 2015: 199).

Malaysia launched financial sector strategic documents to provide strategic directions to the banking and insurance industry on the one hand and the capital markets on the other hand. The *Financial Sector Master Plan 2001-2010* was launched by Bank Negara Malaysia, the central bank of the country, in 2001 to promote a resilient, competitive and dynamic financial system (KPMG undated). The key pillars of the Master Plan included strengthening the regulatory and supervisory framework, developing a domestic financial infrastructure, enhancing competition and domestic capacity, and promoting shareholder and consumer activism. The Master Plan has specific targets for the development of Islamic banking and *takaful* industries that include strengthening operational and institutional infrastructure, stimulating competition, and raising performance standards. Similarly, the *Capital Market Master Plan 2001-2010* was also initiated in 2001 to make the Malaysian capital market internationally competitive in all core areas. One of the key goals of the Master Plan was to establish Malaysia as the International Islamic Capital Market's Center.

With the expiry of the Master Plan, a new set of strategic documents was published to guide the financial sector in the future in 2011. While the *Financial Sector Blueprint 2011-2020* prepared by BNM lays down the key strategic elements of the development of the banking and insurance/*takaful* sectors, the *Capital Market Masterplan 2* produced by the Securities Commission Malaysia does the same for the capital markets for the period 2011-2020. In order to promote Malaysia as an international hub for Islamic finance, the Malaysian Islamic Finance Center (MIFC) was launched in 2006. Another key development of the Malaysian financial system is the International Business and Financial Centre (IBFC) in Labuan. IBFC has a separate regulatory authority which is the Labuan Financial Services Authority (Labuan FSA) created under the Labuan Financial Services Authority Act 1996. In 2010, the Labuan Islamic Services and Securities Act 2010 was promulgated to promote the development of Islamic finance in the IBFC (BNM 2011: 33).

4.4.1. Legal Infrastructure

Supporting Islamic Finance Laws

Malaysia is a federal country which consists of 13 states and one federal territory. The country adopted the common law system and federal laws and statutes govern commercial and financial activities. Malaysian laws and statutes relating to Islamic finance have evolved over time to address the changing circumstances and the development needs of the industry. After the enactment of the Central Bank of Malaysia Act of 1958, Bank Negara Malaysia (BNM), the Central Bank of Malaysia was established in 1959. The act was revised as the Central Bank of Malaysia Act 2009 (CBA 2009) to cater to the new roles of a modern central bank that promotes both monetary and financial stability (BNM 2012). The CBA 2009 makes the BNM responsible for developing a sound, progressive, inclusive and mature domestic financial sector that can deal with the challenges of a globalized and integrated world. The law entrusts the BNM with enhanced regulatory and supervisory powers to oversee financial institutions (banks, insurance and *takaful* companies) and exercise oversight over money and foreign exchange markets and the payment systems. CBA 2009 strengthened BNM's independence and authority and expanded its surveillance and resolution powers to avert risks that could lead to crises (CIBAFI 2015: 85). The Act also clearly defines and strengthens the role of the BNM based *Shariah* Advisory Council (SAC) in *Shariah* governance and legal issues.

Malaysia has separate legislations for Islamic financial institutions. While the Banking and Financial Institutions Act 1989 (BAFIA amended 1993) deals with conventional banking, Islamic banking has mainly been governed by the Islamic Banking Act 1983 (IBA 1983). BAFIA 1993 permits conventional banks to carry out Islamic banking business through windows. Similarly, the Insurance Act of 1996 (amended Insurance Act of 1963) provide the legal basis for the insurance industry, and the *Takaful* Act 1984 governed the establishment and regulation of *takaful* companies.

More recently, the Financial Services Act 2013 (FSA) and the Islamic financial Services Act 2013 (IFSA 2013) were promulgated to provide a sound legal basis for the development of a stable financial sector. The IFSA 2013 consolidated and updated the legal framework for Islamic banks and *takaful* sectors by repealing IBA 1983 and *Takaful* Act 1984. These new legislations provide 'a more cohesive and integrated legal framework that delivers a consistent and comprehensive treatment of risks, thus minimizing the prospects of regulatory arbitrage and gaps' (BNM 2012: 92). These acts not only reinforce the regulatory and supervisory framework to promote stable banking and insurance industries by fostering soundness of financial institutions but also strengthen the business conduct, consumer protection, and integrity of the money and foreign exchange markets (Fen and Tsin 2013).

The Capital Markets and Services Act 2007 (Act 671) (CMSA 2007) governs various aspects of the capital markets in Malaysia. The act has provisions for Islamic securities and Division 6 of the Act deals with issues related to the establishment of a *Shariah* Advisory Council (SAC). The Securities Commission Malaysia (SCM) was established as a self-funding statutory body under the Securities Commission Act 1993 which was superseded by the Securities Commission (Amendment) Act 2015 (SCA 2015). The key role of the SCM is to act as the regulatory body for the promotion and development of capital markets by streamlining regulations that can promote a fair, efficient, secure and transparent securities markets (KPMG undated). The markets under the purview of SC include the Kuala Lumpur Stock Exchange, Malaysia

Derivatives Exchange Market, Malaysian Exchange of Securities Dealing and Automated Quotation, Malaysian Bond Market, Ratings Agencies and Islamic Capital Market.

Tax regimes and impact on Islamic finance

The Malaysian tax system provides tax neutrality to Islamic financial transactions approved by any Shariah Advisory Council (SAC) of the regulatory bodies (i.e., BNM, SCM or Labuan Financial Services Authority). The returns/profits on Islamic financial transactions are considered similar to interest for taxation purposes (PWC 2102: 60). As such, all the tax related issues applying to interest such as interest withholding taxes and tax exemptions equally apply to profits in Islamic finance. Similarly, tax neutrality is also provided in *sukuk* structures whereby the tax implications of buying, selling or leasing of assets are ignored. A Tax Neutrality Committee was set up by the Inland Revenue Board, Ministry of Finance to examine and resolve tax neutrality issues for new Islamic financial products (BNM 2013b, PWC 2012: 63).

Furthermore, the tax regime in Malaysia provides certain positive tax incentives to promote investment in capital markets and also the development of specific Islamic financial products (Krasicka and Nowak 2012, PWC 2012). For example, Islamic banks and *takaful* companies were exempted from income taxes on transactions conducted in international currencies from 2007 to 2016 (MIFC 2016a). For the same period, the stamp duty was exempted on Islamic banking products undertaken in foreign currencies by international Islamic banks. Similarly, expenses incurred on issuance of *sukuk* that are approved by BNM, SC and Labuan FSA could be deducted from taxes until the end of 2015 (PWC 2012: 64).

Dispute Settlement/Conflict Resolution Framework and Institutions

Being a common law country, the commercial disputes including those related to the financial sector are adjudicated in the federal level civil courts. Since the courts consider the laws and statutes of the country when dealing with cases related to Islamic banking and finance, judges face difficulties to interpret the Shariah related issues arising in Islamic financial contracts (Hasan and Asutay 2011). The Central Bank Act 2009 resolves this problem by giving the SAC of BNM a prominent role and authority in dealing with Shariah related issues in disputes. Section 58 of the Act requires a judge to refer Shariah issues to the SAC and Section 57 stipulates the rulings made by SAC in reference to any case in a court or arbitral tribunal to be binding on them (Oseni and Ahmad 2015). Furthermore, a dedicated judge in the High Court is assigned to deal with the disputes related to Islamic finance (Hasan and Asutay 2011: 66). Similarly, the Securities Commission Act 2015 (Part IIIC, 31ZN) stipulates that in cases involving Islamic capital market businesses or transactions, the ruling of SAC of SCM must be consulted by a court/arbitrator or the matter must be referred to the SAC for a ruling. Furthermore, the ruling of the SAC will be binding on the court or arbitrator and other capital market stakeholders such as licensed persons, stock exchanges, clearing houses, listed corporations, etc.

The Kuala Lumpur Regional Centre for Arbitration (KLRCA) was established in 1978 as the first regional arbitration centre under the umbrella of the Asian-African Legal Consultative Organization (AALCO) to carry out domestic and international arbitration in Asia. The government enacted the Arbitration Act of 2005 modeled after the UNCITRAL model law (Jiet 2015) and KLRCA adopted the revised UNCITRAL Rules for Arbitration in 2010. In 2012

KLRCA launched i-Arbitration Rules for resolving disputes arising in Shariah compliant contracts. With i-Arbitration Rules complying with the UNCITRAL Arbitration Rules, KLRCA provides opportunities for arbitrating both domestic and international Islamic finance disputes in an efficient and effective manner (Hodges et. al 2012). Rule 8 of the i-Arbitration Rules stipulates that any *Shariah* issues would be referred to one of the *Shariah* Advisory Councils (SAC) or a *Shariah* expert, agreed upon by all parties, must be referred to for an opinion (KLRCA 2102). KLRCA handled 156 cases in 2103, 20% of these being international cases. The numbers of cases jumped to 226 by the third quarter of 2014 (Jiet 2015, Verghese 2014).

In order to strengthen the legal infrastructure to support the growth and development of Islamic finance, BNM established the Law Harmonization Committee in 2010 (BNM 2011: 114). The objectives of harmonization of national laws and statutes with Islamic financial contracts include achieving certainty and enforceability of the latter and help make Malaysia as a legal reference for the settlement of disputes for international and cross border Islamic transactions.

Bankruptcy and Resolution of Banks

Bankruptcy laws in Malaysia can be distinguished into two types, one for individuals and the other for companies. While the Bankruptcy Act 1967 (BA 1967) and Bankruptcy Rules 1969 (BR 1969) govern bankruptcy of the former, the Companies Act 1965 (CA 1965) and Company Winding-Up Rules 1972 (CR 1972) apply to the insolvencies of companies (Cheah and Yeoh 2009, Kannaperan undated). IFSA 2013 (Part XIV, Division 3) refers to CA 1965 and provides specific insolvency related stipulations for Islamic banks and *takaful* companies. Specifically, Section 217 of IFSA 2013 identifies the priority of payments to different stakeholders in case of a winding up of a licensed Islamic bank and Section 218 does the same for a *takaful* company.

4.4.2. Financial System Regulation and Supervision Framework

The CBA 2009 defines the functions of BNM as promoting a sound, progressive and inclusive financial system and regulating and supervising financial institutions that are subject to the laws enforced by it. Both FSA 2013 and IFSA 2013 entrust BNM with broad and extensive authority to ensure good governance and sound risk management practices in the regulated institutions. BNM has an Islamic Banking and Takaful Department to deal with different issues related to Islamic finance.

BNM (2015) published the Capital Adequacy Framework for Islamic Banks in October 2015, detailing, among others, the capital charges for different types of risks (such as credit, market and operational risks). The guidelines cover various risks arising in different modes of financing such as *murabahah*, *ijarah*, *salam*, etc. One of the novel features of IFSA 2013 is that it distinguishes between Islamic deposits and investment accounts. In line with Shariah principles, returns on investment accounts depend on the performance of assets underlying the account. As such, repayment of either principal or positive returns cannot be guaranteed. Given this feature, the law requires that Islamic banks enhance their risk management practices and also disclose relevant information to protect the investors (BNM 2013: 103). BNM also issued standards for the sound management of Islamic investment accounts in 2014 which includes fulfilling the fiduciary mandates of good risk management and oversight of the investments made from funds from these accounts (BNM 2014: 90).

Under IFSA 2013, *takaful* operators are required to separate their general and family *takaful* businesses and hold separate regulatory capital for each segment by the year 2018 (CIBAFI et. al. 2015: 192). BNM (2013) issued *Risk-Based Capital Framework for Takaful Operators* in June 2013 for General and Family Takaful companies. Among others, the guidelines cover capital charges for credit, market and operational risk arising in *takaful* companies. The risk based capital framework not only improved the capital holdings of *takaful* operators but also improved the underwriting of risks and enhanced IT and information management systems to improve analysis and monitoring of risks (BNM 2013: 100).

The Malaysian securities market operates under the regulatory purview of SCM. The functions of the SCM include regulation of all matters related securities, futures contracts, unit trust schemes, take-overs and merger of companies to promote their development. SCM also monitors and supervises exchange holding companies, exchanges, clearing houses and central depositories, ensures the good business conduct of organizations associated with the securities market, and protects consumers. SCM has a separate department on the Islamic Capital Market dealing with Islamic capital market issues (SCM 2016c). To facilitate the issuance of *sukuk*, SCM has come up with *Guidelines on the Offering of Islamic Securities* and *Guidelines on the Offering of Asset-Backed Securities* in 2004 and *Guidelines on Trust Deeds 2011*.²⁶

4.4.3. Shariah Governance Framework

IFSA 2013 establishes BNM as a regulator of *Shariah* related issues and emphasizes strengthening the *Shariah* governance framework to promote *Shariah* compliance in the Islamic financial sector. Other than providing advice to BNM and financial institutions on *Shariah* related issues arising in financial businesses, Section 51 of the Act identifies the functions of the SAC to include ascertaining the Islamic law of any financial matter by issuing appropriate rulings. IFSA 2013 also strengthens the *Shariah* governance framework at the organizational level (Fen and Tsin 2013).

Part IV of IFSA 2013 covers *Shariah* Requirements that is divided into three divisions: *Shariah* compliance; *Shariah* Governance; and Audit and *Shariah* Compliance. The law makes *Shariah* non-compliance an offence that is punishable and gives BNM extensive powers to intervene when any breach takes place. Specifically, Article 28 (1) of IFSA 2013 requires that a financial institution should ensure that 'its aim and operations, business, affairs and activities are in compliance with *Shariah*' and Articles 28 (5) and 29 (6) stipulates if a person contravenes *Shariah* principles and is noncompliant with standards of SAC 'commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both'.

After the enactment of the Central Bank Act 2009, BNM came up with a regulatory note on "Shariah Governance Framework for Islamic Financial Institutions" in 2010 (BNM 2010). The guidelines outline the two-tier *Shariah* governance infrastructure with the first one dealing with the *Shariah* Advisory Council at the central bank level and second one related to *Shariah* committees at the financial institution level. The Central Bank Act of 2009 defines the SAC as an 'apex authority for the determination of Islamic law for the purposes of Islamic financial business' (BNM 2010: 1). BNM also has a detailed *Shariah* governance framework for IFIs that

²⁶ See <http://www.sc.com.my/legislation-guidelines/sukuk/> for a list of SC guidelines for *sukuk* in Malaysia.

includes issues related to the Shariah Committee and operational matters such as Shariah review, audit, research and risk management.

One of the ways in which the market efficiency can be increased is to use standardized contracts and documents among the financial sector's stakeholders. In this regard, BNM's SAC has approved Shariah parameters for various contracts. Other than approving Shariah parameters for eight contracts (*murabahah*, *mudharabah*, *musharakah*, *wadiah bai al inah*, *ijarah*, *tawarruq* and *hibah*), SAC has issued exposure drafts of several others contracts such as *istisna*, *wakalah*, *kafalah* and *wad* (BNM 2014: 89).

The Shariah Advisory Council (SAC) was established in 1996 at the SCM to oversee Shariah issues related to Islamic capital markets. Among other things, the Securities Commission Act (SCA) 2015 (Part IIIC) defines the various functions of the SAC and the method of appointment and qualifications of the members of the SAC. Similarly, the SCA 2015 (Part IIIC, 31ZI) stipulates the SAC at SCM will have 'authority for ascertainment of the application of Shariah principles for the purposes of Islamic capital market business or transaction.' SCM issued a regulatory note on 'Registration of Shariah Advisers Guidelines' in 2009 to ensure the quality of Shariah advisors engaged with financial institutions dealing with capital markets.

The SAC at SCM plays an important role in the development and innovation of new Islamic products in the Malaysian capital market by providing advice on Shariah principles and compliance (CIBAFI et. al 2015: 232). The criterion to screen stocks was changed in 2013 to align with global Shariah standards (CIBAFI 2015: 216). The new approach adopts two-tier screening, one at the industry level to discard companies involved in activities considered impermissible and the other one using financial ratios to vet companies as Shariah compliant. The goal of the revision is to enhance the competitiveness of Malaysia's stocks and mutual funds and increase the international appeal of Islamic capital market products and attract capital inflows from overseas.

4.4.4. Liquidity Infrastructure

BNM has introduced various measures to support liquidity management in Islamic finance. Other than a sound regulatory, supervisory and Shariah framework, other initiatives of liquidity infrastructure include introducing a variety of Shariah compliant liquidity instruments, establishing infrastructure that facilitates the issuance of Islamic financial instruments, promoting an active secondary market for Islamic financial securities and instituting a strong financial safety-net (BNM 2011: 62). BNM issued *Guidelines on Islamic Inter-bank Money Market (IIMM)* in December 1993 and the IIMM was introduced in January 1994. Various instruments are used to manage liquidity of Islamic banks in IIMM. The instruments include *Mudharabah* Interbank Investment (MII), *Wadiah* Acceptance, Government Acceptance Issue (GII), Bank Negara Monetary Notes-I (BNMN-i), Sell and Buy Back Agreement (SBBA), Cagamas *Mudharabah* Bonds (SMC), When Issue (WI), Islamic Accepted Bills (IAB), Islamic Negotiable Instruments (INI), Islamic Private Debt Structures, *Ar-Rahnu* Agreement (RA-i) and *Sukuk* BNM *Ijarah* (SBNMI) (BNM 2016b). In terms of safety net, BNM also has lender of last resort facilities for Islamic banks (BNM 2011: 63).

IFSA 2013 also strengthens the legal framework for the operations of Islamic money markets. Article 153 of the act entitled 'Prohibited conduct in Islamic money market and Islamic foreign exchange market' requires that conduct and activities in these markets should not contradict

the Shariah. Any violation of Shariah is considered an offence that is punishable by 'imprisonment not exceeding ten years or a fine not exceeding fifty million ringgit or both' [IFSA 2013, Article 153 (3)].

In line with the Basel III regulatory standards, BNM issued regulatory guidelines on the Liquidity Coverage Ratio (LCR) in 2015 covering both conventional and Islamic banks. Among others, BNM (2015b) identifies the features of different levels of High Quality Liquid Assets (HQLA) for the determination of LCR for Islamic banks. Level 1 HQLA includes placements with BNM using Commodity Murabahah programs and marketable securities issued by BNM such as Bank Negara Monetary Notes-I, BNM Mudharabah Certificates. Similarly, sukuk issued by the International Islamic Liquidity Management Corporation (IILM) can be held to meet liquidity needs for USD based assets (BNM 2015b: 14). The adoption of the LCR by banks will be gradual with its partial adoption starting in June 2015 and full compliance expected by the beginning of 2019 (BNM 2014: 86).

4.4.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency and Disclosure

IFSA 2013 (Division 3) requires that licensed financial institutions should maintain proper accounting standards and prepare financial statements that can be conveniently audited. Furthermore, the Act stipulates under 'Standards of business conduct' (Article 135) that BNM may specify standards related to transparency and disclosure requiring financial institutions to provide information that is accurate, clear, timely and not misleading. The act stipulates that the Malaysian Financial Reporting Standards (MFRS) (which are based on the International Financial Reporting standards IFRS) issued by the Malaysian Accounting Standards Board (MASB) should be used for accounting purposes, but it also provides that BNM can specify other standards to reflect specific modifications or exceptions to MFRS (BNM 2015c: 1).

BNM's regulatory guidelines on *Financial Reporting for Islamic Banking Institutions* (BNM 2015c) require Islamic banks to prepare financial statements using MFRS. However, guidelines hold that consideration should be given to accounting of Islamic transactions by examining both Shariah requirements and their economic effects. The banks are required to disclose, among other things, the types of Islamic deposits, the class of Shariah contracts used (such as *murabahah*, *ijarah*, *mudharabah*, etc), obligations to *zakat* payments and income derived from Shariah non-compliant activities. Islamic banks must include a Shariah Committee's Report as a part of the Annual Report and the regulatory guidelines provide the minimum disclosure that should be included in the report (BNM 2015c: 8-9).

BNM has also issued separate financial reporting guidelines for *takaful* operators. *Takaful* operators are also required to prepare their financial reports in 'accordance with MFRS to the extent that the standards are consistent with *Shariah* principles' (BNM 2015d: 5). The guidelines indicate specific reporting issues arising in *takaful* business. For example, *takaful* operators are required to present the assets and liabilities of the *takaful* fund and those of the *takaful* operator separately and also issues related to how *qard* given to the *takaful* fund should be accounted for.

SCM issued *Guidelines on Sukuk* in 2014 which includes a section entitled "Disclosure of Material Information". The Guidelines stipulate that if the *sukuk* is not listed on Bursa

Securities, the issuer of the sukuk must provide the latest audited financial statements to investors throughout the life of the certificate. Before issuing an Islamic medium-term note (MTN), the issuer must make available a pricing supplement that specifies, among others, the credit rating, coupon/profit rate, and how the proceeds will be utilized (BNM 2014: 27).

Rating Agencies

Credit Rating Agencies (CRAs) operate under the purview of the SCM which first introduced the regulatory framework for CRAs in 2006. The regulatory guidelines were revised in 2010 after the global financial crisis when IOSCO came up with the new *Objectives and Principles of Securities Regulations*. SCM published *Guidelines on Registration of Credit Ratings Agencies* to regulate the CRAs in 2011. The Guideline identifies 'Approach to rating *sukuk* (Islamic bonds)' as one of the methodologies that should be developed and disclosed by CRAs.

The country has two registered ratings agencies: RAM Rating Services Berhad (RAM) and Malaysian Rating Corporation Berhad (MARC). Other than ratings corporations, RAM rates securities/issues to ascertain the capacity and willingness of the issuer to meet the financial obligations. Currently, RAM provides short-term and long-term ratings for debt-based sukuk and partnership based sukuk. While the ratings provide indications on the credit-worthiness of different *sukuk*, they do not assess the Shariah compliance features of these structures.

MARC also provides short-term and long term ratings for Islamic capital market instruments which include sukuk and those issued using various Shariah compliant modes of financing and non-fixed income obligations (MARC 2011). MARC also provides ratings on the status of corporate governance of Islamic financial institutions.

4.4.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

The Financial Sector Blueprint 2011-2020 recognizes the empowerment of consumers by protecting and educating them to be one of the key enablers of the development of the financial sector in the country (BNM 2011). While the Consumer Protection Act of 1999 covers consumer protection issues of all types of consumers, specific issues arising for consumers of the financial sector can be found in IFSA 2013 and the different regulatory guidelines of BNM. IFSA 2013 introduced higher levels of consumer protection and Shari'ah governance in *takaful* companies. Part IX of the Act entitled *Business Conduct and Consumer Protection* deals with various issues that includes business conduct, complaints, disputes, information and secrecy, etc.

BNM has taken different initiatives that enhance consumers of financial products and the Consumer and Market Conduct Department, a unit within BNM, oversees consumer related issues. The regulatory guidelines require all financial institutions regulated by BNM to have complaint units where consumers can lodge complaints that need redressing (BNM 2016b). An agency called Agensi Kaunseling dan Pengurusan Kredit (AKPK) was established by BNM in 2006 to provide advice, education and debt counseling on debt management to individuals. The Financial Mediation Bureau (FMB) was set up to provide an efficient platform to resolve the disputes, claims and complaints of consumers of financial institutions including Islamic banks and *takaful* operators.

IFSA 2013 (Article 138) also stipulates the BNM can take the initiative of the opening up of a financial ombudsman scheme to ensure the fair and effective dealing of complaints and resolution of disputes. Accordingly, the Ministry of Finance on the recommendation of BNM issued the Islamic Financial Services (Financial Ombudsman Scheme) Regulations 2015 to initiate the Ombudsman Scheme for the consumers of the Islamic financial sector (BNM 2015).

BNM takes an active role in enhancing financial literacy in Malaysia. Other than setting the goals in its strategic documents, BNM has taken various steps implement the strategy. The initiatives include integrating financial education in the school curriculum, establishing financial clubs in schools and adult education by Agensi Kaunseling dan Pengurusan Kredit (Ali 2013). Furthermore, different webpages are developed that promote financial literacy and education. The websites include <http://www.bankinginfo.com.my/> which has information on Islamic banking, <http://www.insuranceinfo.com.my/> which has sections on *takaful*, and <http://www.duitsaku.com/> which provides information on financial planning for children and the youth.

Deposit Insurance

The Financial Sector Master Plan 2001-2011 of Malaysia identified the establishment of a deposit insurance scheme as a safety-net for depositors under the broader framework of consumer protection (BNM 2001: 17). The Malaysia Deposit Insurance Corporation Act 2005 initiated the deposit insurance scheme in Malaysia. The Act established the Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia PIDM) to administer the system of protecting deposits of both conventional and Islamic banks (BNM 2012). To further enhance the stability of the financial system, the Act of 2005 was superseded by the Malaysia Deposit Insurance Corporation Act 2011 to widen the safety net extending the protection and insurance coverage beyond deposits.

PIDM provides deposit insurance to depositors of both conventional and Islamic banks. For the latter, it uses a contract of guarantee with a fee that is approved by the SAC of BNM (IADI 2010: 14). Before the enactment of IFSA 2013, Islamic demand, savings and investment deposits were covered by PIDM. However, the IFSA 2013 distinguishes between deposits and investment accounts with the latter having the feature that it bears the risks of investments. One of the implications of this new classification is that while deposits are protected by the deposit insurance scheme, the investment accounts are not covered (CIBAFI et. al 2015: 163).

4.4.7. Human Capital & Knowledge Development Framework

In line with the Financial Sector Masterplan 2001, Malaysia has invested heavily in developing talent and professionalism for the financial sector in general and the Islamic financial sector in particular. The new strategy document, the Financial Sector Blueprint 2011-2020 identifies talent development to support a more dynamic financial sector to be a key enabler of the development of the financial sector in the country (BNM 2011).

Under the leadership of BNM, various educational and training institutions have been established to cater to the different needs of the financial sector. The initiatives include the establishment of the International Centre for Leadership in Finance (ICLIF) in 2003 to train senior managers in strategic and leadership development and Financial Institutions Directors Education Programme (FIDE) in 2008 to train members of the board of directors in

governance, risk management and strategic issues. In 2010, ICLIP and FIDE merged to form the ICLIP Leader & Governance Centre to cater to the training needs of board members and senior management. The Financial Sector Talent Enrichment Programme (FSTEP) was established in 2007 to provide sound financial knowledge and skills to entry-level graduates (BNM 2011: 30-31).

While professionals of Islamic financial institutions can avail the training from these institutions, BNM has taken initiatives to enhance the knowledge and skills base for the Islamic financial sector. The International Centre for Education in Islamic Finance (INCEIF) was established in 2006 as a global university of Islamic finance to provide academic and professional education and training. In 2008, the International *Shariah* Research Academy for Islamic Finance (ISRA) was established to promote applied research *Shariah* and Islamic finance (BNM 2011: 30-31).

Malaysia is among the leading countries providing education and training in Islamic finance. The country is ranked first in Knowledge Indicator in Islamic Finance by ICD-TR (2015: 110) with 30 educational institutions offering Islamic finance degrees and 46 institutions offering Islamic finance courses in 2014. Malaysia is also one of the most research active countries in Islamic finance and produced 401 articles published in peer reviewed journals and producing 121 research papers in the discipline.

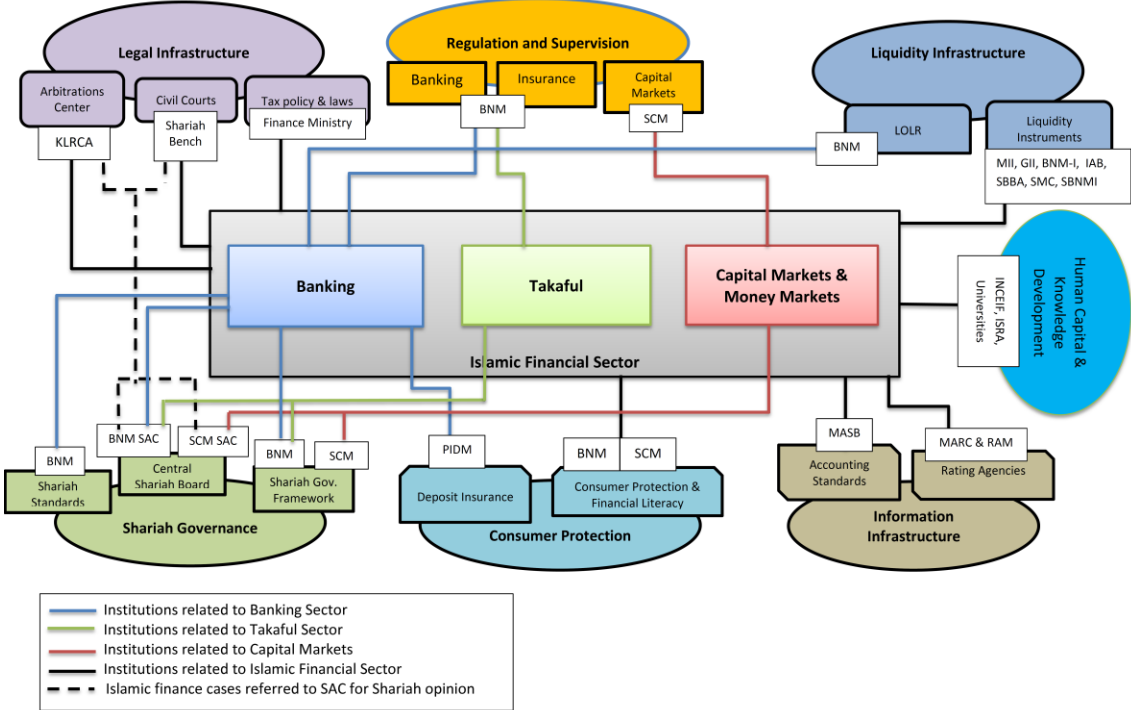
To make Malaysia the global hub and learning center for Islamic finance education, the International Council of Islamic Finance Education (ICIFE) was established in 2014 under the initiative of the Ministry of Education of Malaysia. The main objective of ICIFE is to 'increase and maintain the professionalism of the educators in Islamic finance at the national and international levels'.²⁷ The vision of the organization includes becoming 'a premier global organization for providing dynamic leadership in quality assurance and enhancement of Islamic Finance Education worldwide' and to 'make significant contributions to the intellectual domains of Islamic Finance and other relevant fields of professional practice'.

4.4.8. Summary and Conclusions

Malaysia has one of the most robust financial architecture for Islamic finance which reflects the political will of the government of Malaysia to promote the industry. Development of the Islamic financial sector is part of a broader strategy and various public bodies have taken initiatives to accomplish these goals. The laws have been updated to deal with changing environments, and the regulatory bodies have played a pro-active role in promoting different segments of the industry. In particular, BNM and SCM has assisted in the development and promotion of Islamic markets and instruments and also contributed to a sound *Shariah* governance regime at both the regulatory and organizational levels. The government has also played an active role in advancing education and training in Islamic finance. Many educational institutions are engaged in research and providing education in Islamic finance to create an adequate and appropriate human capital that can propel the industry forward.

²⁷ <http://icife.net/about/>

Chart 4.4: Islamic Financial Architecture Institutions—Malaysia



4.5. Nigeria

The Islamic finance sub-sector comprising Islamic banks, *takaful* companies and the Islamic capital market is relatively new in Nigeria compared to their conventional finance counterpart. Habib Bank was the first conventional bank in Nigeria to be granted licenses to operate an Islamic banking window in 1992 following the amendment of Banks and Other Financial Institutions Act (BOFIA) in 1991 that recognized the profit and loss sharing banking model. While the window commenced operations in 1999, it did not survive as Habib Bank as it transformed into Bank PHB after a merger with Platinum Bank in 2005 and was liquidated in 2011.

Islamic finance again got a boost in 2011 when the Central Bank of Nigeria (CBN) issued the guidelines for the regulations and supervision of institutions offering non-interest financial services in Nigeria. Following the release of the guidelines, a fully-fledged Islamic Bank (Jaiz Bank), Stanbic IBTC and Sterling Bank Islamic Banking Windows as well as Tijara microfinance Islamic bank were licensed and commenced operations between 2011 and 2014. These four (4) institutions constitute the Islamic banking sub-sector.

The size of the Islamic banking sub-sector remained small in the entire banking industry. The total assets, deposits and financing (credit) of the sub-sector according to the CBN's FinA (Financial Analysis) which stood at USD276 million, USD202 million and USD129 million as of December 2015 accounted for only 0.20%, 0.23% and 0.19% respectively of the banking industry. Even though the size is very small, the growth rate of the three indicators outperformed those of the conventional financial institutions as total assets, deposits and financing grew by 23.74%, 44.30% and 18.04% against the values of 2.78%, -2.96% and 5.72% recorded for conventional financial institutions in 2015, respectively.

The *takaful* segment of Islamic finance in Nigeria is not as vibrant as the Islamic Banking segment as *takaful* is being offered only as a product. As of December 2015, there were three conventional insurance companies offering *takaful*. A significant milestone in *takaful* was, however, recorded when the National Insurance Commission (NAICOM) issued the Guidelines for *Takaful-Insurance* in 2013.

Similarly, the Nigerian Islamic capital market is comprised of one Islamic fund manager managing the Lotus Capital Halal Fund and three (3) conventional fund managers managing four Islamic/Ethical Funds windows (Stanbic IBTC- Iman Fund, Stanbic IBTC Ethical Funds, Zenith Ethical Funds, and ARM Ethical Funds) and one ETF (Lotus Halal ETF). Furthermore, the Osun State Government issued a *sukuk* and the Nigeria Stock Exchange (NSE)-Lotus Islamic Index was created in 2009 and launched in 2012. It was the first index to track the performance of 15 *Shariah* compliant equities listed on the NSE. According to data obtained from the Securities and Exchange Commission (SEC), the total Net Asset Value (NAV) of the five Islamic/Ethical funds was USD24 million at the end of 2015, representing only 1.8% of USD1.3 billion for the entire mutual funds market.

4.5.1. Legal Infrastructure

Supporting Islamic Finance Laws

Nigeria has no dedicated laws for Islamic finance. However, the legal framework for Islamic finance was derived from the existing conventional finance laws by leveraging on some provisions to establish Islamic financial institutions. The main laws that affect the industry were: Company and Allied Matters Act (CAMA) 1990, Banks and Other Financial Institutions Act (BOFIA) 1991, Central Bank of Nigeria (CBN) Act 2007, Investment and Securities Act (ISA) 2007, National Insurance Commission (NAICOM) Act 1997, and the Nigerian Deposit Insurance Act 2006.

CAMA 1990 requires corporate entities to register themselves before operating as legal business organizations. They should also satisfy the relevant provisions made in BOFIA 1991, the CBN Act 2007, and the Regulation on the Scope of Banking Activities and Ancillary Matters, No. 3, 2010 for it to function as a bank. Specifically, the provisions of Sections 2(1); 23(1); 52; 55(2); 59(1)(a); 61 of BOFIA 1991 and 33 (1) (b) of the CBN Act 2007 require that no entity should carry out any banking business in Nigeria except if it is duly incorporated in Nigeria and holds a valid banking license. The Act empowers the Governor of the CBN to make rules, regulations and issue guidelines for the operation and control of all institutions under the supervision of the CBN. The provisions also empower the CBN to supervise and regulate the activities of specialized banks and also exempt profit and loss sharing banks from the Act's provisions. Furthermore, Section 4(1)(c) of the Regulation on the Scope of Banking Activities and Ancillary Matters, No. 3, 2010 permits only three types of banks that can be licensed and operated in Nigeria and these are: Commercial, Merchant and Specialized banks, which include non-interest banks, microfinance banks, development banks and mortgage banks.

Section 7 of the NAICOM Act 1997 empowers the Commission to establish and approve standards, conditions and warranties applicable to all classes of the insurance business in Nigeria. Based on this provision, *takaful* businesses become feasible.

The provisions of sections 13, 14, 154, 222, 223 and 313 of the Investment and Securities Act 2007 provide that the Securities and Exchange Commission (SEC) has powers to register and regulate Securities Exchanges, corporate and individual capital market operators, venture capital funds and collective investment schemes in whatever form; register bonds issued by the Government; establish specialized departments for the purpose of regulating and developing the Nigerian capital market; and empower the Commission to make rules and regulations that will ensure the smooth workings of the capital market. Under these provisions, the establishment of the Islamic Fund and listing of the *Sukuk* by SEC becomes possible.

Tax regimes and impact on Islamic finance

For the effective administration of taxes, the Federal Inland Revenue Service (FIRS) Act was enacted and passed into law in 2007. Sections 8(1)(c) and (d) and 61 of the Act empower the FIRS to collect, recover and pay to the designated account any tax, review the tax regimes, as well as make rules and regulations which it considers necessary to bring into force the full effect of the provisions of the Act. Based on these provisions, the FIRS issued guidelines on tax implications for non-interest banking in Nigeria in 2013. The guidelines were meant to address

the adverse impact of tax regimes on Islamic finance which was identified to include a non-level playing field between the Islamic financial institutions (IFIs) and Conventional financial institutions (CFIs) as well as double taxation.

The guidelines highlighted all the tax issues in various Islamic financing products and suggested the tax treatment in them. Specifically it discusses the unique features of *sukuk* and provides that the coupon/gains arising out of any *sukuk* arrangement should be treated as interest accruing to the financial institution and be subject to the provisions of the Companies income Tax Act and that *sukuk* should be treated as conventional bonds for the purposes of tax. Specifically, the guidelines give a general provision for any Islamic finance structure that might arise and that is not discussed in the guidelines as follows: “Wherever Withholding Tax (WHT), Value Added Tax (VAT), Capital Gains Tax (CGT) and Stamp Duty (SD) arise twice in any Islamic finance structure on a single transaction different from the product/services discussed in the guidelines, the second transaction between the IFI and its customer shall be equivalent to financial transaction similar to bank/customer relationship in CFI”.

Dispute Settlement/Conflict Resolution Framework and Institution

Dispute resolution in Nigeria’s financial sector is achieved in two common ways: litigation and arbitration. Litigation involves the Federal High Court while arbitration involves an approved arbitrator for the purpose of settlement. For effective dispute/conflict resolution, the Bankers’ Committee (comprising of CBN and all deposit money banks) has initiated some resolution mechanisms by establishing the Ethics and Professionalism Sub-committee for settling disputes between banks. In case of litigation, according to Section 25(1) (d) (j) of the Constitution of the Federal Republic of Nigeria 1999, it is only the Federal High Court that can decide on cases relating to banking, banks, the Central Bank of Nigeria, other financial institutions, bankruptcy and insolvency. Thus, the dispute/conflict resolution mechanism does not differentiate between Islamic and conventional finance. However, in the case of Islamic financial institutions, the contract document signed with the customer provides for arbitration between the bank and the customer with one member of the Advisory Committee of Experts (ACE - the bank’s *shari’ah* board) in attendance, and, where a case cannot be resolved, the case is referred to an appropriate Court for adjudication. Since Nigeria has yet to witness any court cases involving Islamic finance and since Nigeria’s laws are fashioned after English laws, any such cases that may occur will likely be adjudicated in a similar manner as was handled in some Islamic finance cases in the UK as reported by Hasan and Asutay (2011).

Bankruptcy and Resolution of Banks

The laws governing the bankruptcy and resolution of banks are embedded in Sections 35–42 of Banks and Other Financial Institutions Act 1991 and Sections 2, 37 – 44 of the Nigerian Deposit Insurance Corporation (NDIC) Act. It states that where a bank is likely to become unable to meet its obligations or is about to suspend payment to any extent or it is insolvent or where after an examination the CBN is satisfied that the bank is in a grave situation, the Governor of the CBN may take drastic actions in order to revive the bank. If after taking such actions the condition of the bank does not improve, control and management of the bank is transferred to the NDIC for further management. However, in the event that the bank managed by the NDIC cannot be rehabilitated, the NDIC can recommend to the CBN other resolution measures that may include the revocation of the bank’s license. Once the license is revoked, the NDIC should apply to the Federal High Court for a winding up of the bank.

When a bank is liquidated, the NDIC Act stipulates the rights of depositors and other creditors. After deducting the deposit insurance claims from the amount realized, the NDIC should pay to depositors and other creditors the net amount available for distribution to them. It is only after all depositors and creditors are settled that the investors are to be treated. This conventional banks' bankruptcy and resolution framework also apply to Islamic banks as well and there is no separate framework to deal with them.

4.5.2. Financial System Regulatory and Supervisory Framework

The key regulatory bodies in the Nigerian financial sector are the CBN, the NDIC, the NAICOM, the SEC and the Corporate Affairs Commission (CAC). These bodies derive their regulatory powers from the Acts establishing them as listed in the supporting laws above. The CAC registers corporate entities, the CBN provides oversight functions on the banking industry, the NAICOM regulates the insurance industry, and the SEC oversees the capital market in Nigeria. The oversight functions of the CBN are complemented by the NDIC that is empowered by the NDIC Act which requires a licensed bank to submit returns and information from time to time.

Based on the provisions of the CBN and NDIC Acts, these two bodies issue guidelines for the regulation and supervision of institutions offering non-interest financial services in Nigeria and Non-Interest Deposit Insurance Schemes based on the principles Islamic commercial jurisprudence in 2011 and 2015 respectively. The guidelines highlighted additional license requirements to include evidence of a technical agreement executed by the promoters of the proposed institution with an established and reputable Islamic bank or financial institution clearly specifying the role of the two parties which should subsist for a period of not less than 3 years. Moreover, conventional banks are allowed to open a subsidiary, a window or a branch of Islamic banking. Separate guidelines for the Islamic banking window's operations were also released in 2011.

Similarly, NAICOM issued *Takaful* guidelines in 2013 as the primary regulatory framework with regards to *Takaful-Insurance*. The Guidelines allow for fully-fledged *Takaful-Insurance* Operators and a *Takaful-Insurance* window of a conventional insurance institution. SEC also issued rules 569-588 to regulate the *sukuk* market.

The regulatory bodies in the financial sector discharge their responsibilities through their regulatory and supervisory departments. These departments handle both conventional and Islamic financial institutions. However, each of these departments has a dedicated unit or team of Examiners that handle the Islamic financial institutions.

The Supervisory departments undertake both onsite and off-site supervisions of all financial institutions under their purview. The onsite supervision entails visiting the institutions to examine their books while off-site entails analysis of their periodic returns. These processes apply to both conventional and Islamic financial institutions. However, for the Islamic financial institutions, review of *Shari'ah* Governance and *Shari'ah* Audit is added to the onsite process. Part of the supervisory process requires that the capital requirements as provided by IFSB 15 are applied to Islamic financial institutions. However, the relevant regulatory bodies have yet to implement IFSB 15 and 16. As such, the capital requirements under Basel 1 and Pillar 2 of Basel 2 are currently applied to Islamic financial institutions. The two IFSB Standards are planned for implementation soon.

The capital of the Islamic financial institutions consists of only Tier 1 core capital. At present, there are no *Shariah* compliant instruments to meet the Basel III additional Tier 1 and Tier 2 capital requirements as there are no *Musharaka Sukuk* and *Mudarabah/Wakalah Sukuk* issued by the Islamic financial institutions which could qualify as additional Tier 1 and Tier 2 respectively. The Supervisory Departments also monitor some key financial soundness indicators (FSIs) for all banks. For Islamic banks, the indicators as suggested by IFSB are monitored.

4.5.3. Shariah Governance Framework

In Nigeria, there is no central national *Shariah* board. Rather, CBN has established a *Shariah* Supervisory Board (SSB) known as the Financial Regulation Advisory Council of Experts (FRACE) and *Takaful* Advisory Council (TAC) which has been established in NAICOM while the SEC has no such body. These Councils act as advisory bodies on *Shariah* issues and also review and approve product papers/and advert materials emanating from Islamic financial institutions as well as screen and approve the appointment of the institutions' members of the Advisory Committee of Experts (ACE), which is the equivalent of a *Shariah* Advisory Committee (SAC).

The Guidelines on *Shariah* Governance and *Takaful* issued by CBN in 2010 and NAICOM in 2013 respectively clearly states that all licensed Islamic financial institutions should establish an Advisory Committee of Experts (ACE) that must be approved by the regulators' Advisory Council of Experts. In 2013, SEC issued standards requiring Islamic funds and issuers of *Sukuk* to appoint a *Shariah* adviser who could be either a person or a corporate body.

According to the CBN and NAICOM's guidelines, the Advisory Committee of Experts should directly report to the Board of Directors of the institution with a dotted line reporting a relationship to the MD/CEO. It also requires that the Advisory Committee of Experts have a minimum composition of three (3) members who should be individuals and not corporate bodies and must have an academic qualification or possess necessary knowledge in the sciences of the *Shariah* with particular specialization in the field of Islamic Transactions/Commercial Jurisprudence (*fiqhul mu'amalat*). It also recommended that members should have good knowledge of *Usul al Fiqh*, written Arabic, spoken Arabic and English, as well as good exposure in the areas of business or finance especially Islamic Finance. The appointment of the Advisory Committee of Expert members should be for a renewable term of four years subject to a maximum of three terms. The guidelines also provided the basis for disqualifying Advisory Committee of Expert members as well as imposing restrictions on the members such as not allowing any individual to belong to more than one Advisory Committee of Expert of financial institutions in the same industry.

The guidelines further identified the duties and the responsibilities of the Advisory Committee of Expert to include, among others, advising the institution's Board and Management on *Shariah* related matters, reviewing and endorsing *Shariah* related policies and guidelines, endorsing and validating documents for new products and services to ensure compliance with *Shariah* requirements, and issuing written *Shariah* opinions on new products, ensuring that the necessary ex-post considerations are observed after the product offering stage, assisting or advising related parties to the institution on *Shariah* matters upon request, providing support to the institution in respect of questions or queries that may be raised regarding the *Shariah* compliance of its products, issuing recommendations on how the institution can best fulfill its

social role, as well as promoting non-interest banking and finance and assist the internal audit of the institution on *Shariah* compliance audit.

Additionally, the guidelines require institutions to comply with the IFSB/AAOIFI *Shariah* governance guidelines as they are explicit on the guiding principles relating to Competency, Independence, Confidentiality and the Consistency of the framework of *Shariah* governance. However, there is no explicit provision requiring the institutions to use AAOIFI *Shariah* standards.

Regarding *sukuk*, rule 570 (3) of the SEC requires that all *Shariah* principles and concepts applied in structuring an issue, offer or invitation of *sukuk* must be consistent with the general *Shariah* rulings, principles and concepts as approved by the AAOIFI or any other standard setter recognized by the Commission.

At the institutional level, the guidelines issued by the CBN and NAICOM require that there should be a dedicated Internal *Shari'ah* Compliance Unit comprising of officer(s) with appropriate qualifications and experience in Islamic Commercial Jurisprudence and conventional finance to serve as the first point of reference for *Shari'ah* compliance issues. The *Shari'ah* Compliance Unit also serves as the secretariat to the Advisory Committee of Experts. The SEC's rule 492, however, requires the Fund Manager to place appropriate systems and mechanisms within its internal audit requirements to monitor *Shariah* compliance.

4.5.4. Liquidity Infrastructure

The liquidity market in Nigeria is dominated by deposit money banks (DMBs), merchant banks and microfinance institutions. The major instruments in the liquidity market according to the Prudential Guidelines issued by the CBN in 2010 include among others: Nigerian Treasury bills (NTB), Nigeria Treasury Certificates (NTC), CBN Certificates, Certificates of Deposit (CD), Commercial Papers (CP) and Banker Acceptances (BA).

The Islamic financial institutions in Nigeria are constrained by the interest-bearing nature of these instruments to actively participate in the liquidity market. It is against this background that the CBN introduced three (3) non-interest financial instruments in 2012 to facilitate liquidity management for the Islamic financial institutions as follows: CBN Safe-Custody Account (CSCA), CBN Non-Interest Note (CNIN), and CBN Non-Interest Asset Backed Securities (CNI-ABS). The CSCA is based on the *Wadiah* contract between a depositing financial institution and the CBN with CBN being the custodian. At the discretion of the CBN, the depositing institution will be given a *hibah* of which the amount will be decided by the CBN's Committee of Governors. The CNIN is a financial paper evidencing an interest free loan instrument between an Islamic financial institution (Lender) and the CBN (Borrower) which entitles the Islamic financial institution to raise a corresponding interest-free loan from the CBN. The CBN Non-Interest Asset Backed Securities (CNI-ABS) involves the securitization of CBN holdings in International Islamic Liquidity Management's (IILM) *sukuk* and/or *sukuk* in multilateral organizations in which Nigeria is a member. Currently only CSCA and CNIN are activated while the CNI-ABS is yet to be activated. In addition to these three instruments, the *ijara sukuk* issued by the Osun State Government offers liquidity management avenue for the Islamic financial institutions. These four available non-interest instruments for liquidity management in Nigeria, however, do not meet the requirements of High Quality Liquid Assets (HQLA) as stipulated by IFSB 12 and this implies the infeasibility of Liquidity Coverage Ratio

determination for Islamic financial institutions in Nigeria. It is in realization of this liquidity management challenge that the CBN in June 2015 reduced the Liquidity Ratio (LR) of the Islamic financial institutions to 10% from the statutory 30%.

The CBN can use the CBN Non-Interest Note (CNIN) to undertake its function as a lender of last resort in a *Shariah* compliant manner. This scheme starts by CBN determining the amount and tenor of the first loan and then announcing the details of its offer to borrow to the participating Islamic financial institutions. At any point in time after the maturity of the first loan (within 12 months after maturity), the Islamic financial institution is entitled to a free interest loan, the amount of which will be a multiple of the amount involved in the first loan to the extent needed and the maturity will be half the maturity period of the first loan.

4.5.5. Information Infrastructure and Transparency

Islamic Accounting and Auditing Framework/ Transparency and Disclosure

The guidelines for the regulation of Islamic financial institutions require the institutions to comply with the Generally Accepted Accounting Principles (GAAP) codified in local standards and the International Financial Reporting Standards (IFRS)/International Accounting Standards (IAS) and that, for those transactions, products and activities not covered by these standards, the relevant provisions of the financial accounting and auditing standards issued by the AAOIFI should apply.

The regulatory bodies in the financial sector have, at various times, issued revised codes of corporate governance that emphasize the need for transparency and complete disclosure by financial institutions. The CBN issued the revised codes in 2014, SEC in 2011, while the NAICOM issued the corporate governance codes in 2009. The codes encouraged financial institutions to make robust disclosure beyond their statutory requirements. In addition, Islamic financial institutions are required by regulation to also comply with disclosure standards issued by the following standard setting bodies: AAOIFI, IFSB and the Financial Reporting Council (FRC).

Rating Agencies

According to the SEC, there are five (5) licensed domestic credit rating agencies registered in Nigeria which provide credit rating on securities and *sukuk* issuance in the country. There is however, no rating agency in Nigeria to provide *Shariah* rating of Islamic banks and *sukuk* structures.

4.5.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

In Nigeria, consumers are generally protected by the Consumer Protection Council (CPC). Additionally, consumers of financial services are given protection by the regulators of the financial sector. Sections 2 of the CBN Act and 57 of BOFIA empowered the CBN to develop the Consumer protection framework. Similarly, section 8 (a) of the NAICOM Act 1997 allowed NAICOM to establish a Complaints Bureau Unit (CBU) for addressing consumer insurance-related issues. The Investment and Securities Act 2007 requires securities exchanges to

establish an investor protection fund to compensate investors who suffer pecuniary loss arising from insolvency, bankruptcy or negligence of a dealing member firm. These form the laws that provide the basis for both conventional and Islamic finance consumer protection.

CBN also established the Consumer Protection Department in 2012 to co-ordinate complaints arising from Customer interactions with the banking sector as well as the Payment Systems Policy and Oversight Office to address issues relating to payment systems. Additionally, the National Assembly enacted the Financial Ombudsman Act in 2015 which aims to establish the Nigerian Financial Ombudsman Office for the resolution of disputes within the financial sector. Good governance and conduct of businesses are critical in maintaining consumer confidence in the financial system. It is in the realization of this that the CBN developed the code of corporate governance based on the IFSB 3 standards for implementation by the Islamic financial institutions under its purview, though this is still in draft form. However, a guideline on a good conduct of business practice based on the IFSB requirements is yet to be developed.

Institutional arrangement put in place to address the issue of consumer protection in the financial sector include setting up units/departments by the regulators to deal with consumer complaints emanating from both Islamic and conventional financial institutions. To ensure that *sukuk* investors are properly protected, the SEC issued robust and comprehensive guidelines for the issuance of *sukuk* (rules 569 – 588). An arrangement is also being made to set up the financial ombudsman office to arbitrate on consumer related issues.

The CBN is responsible for the financial literacy programme in the country. As a critical component of the Financial Inclusion Strategy, the CBN developed a Financial Literacy Framework (FLF) in 2013. The document articulates a strategic direction for a multi stakeholder approach to the delivery of financial education programs across various target groups of the population in Nigeria.

At the implementation stage of the FLF, the Consumer Protection Department of CBN embarked on several consumer education activities aimed at improving the financial literacy levels of consumers of financial services. Notable activities were: Financial literacy mass awareness and sensitization campaigns across the six geo-political zones of the country, school reach out and mentoring programmes to inculcate the right financial habits and skills in children, TV appearances, radio phone in programmes and print media to educate members of the banking public of recent consumer protection regulations, and school curriculum developments to include a financial literacy curriculum for primary and high schools in Nigeria. For most of these, a presentation on Islamic finance was made in order to increase awareness on Islamic finance.

Deposit Insurance

The NDIC introduced a framework for Non-Interest Deposit Insurance Scheme (NIDIS) in 2012 to cover the Depositors of Islamic banks in Nigeria. According to Yakasai (2015), the NIDIS in operation was adopted from the Malaysia Deposit Insurance Scheme model of the *Kafalah bil Ujur* [Fee-based Guarantee] *Shari'ah*-Contract. The scheme is compulsory for all forms of Islamic banking. Under the scheme, the Maximum Deposit Insurance Coverage (MDIC) for all Islamic Banking Institutions is the same as the conventional banks, which is presently ₦500,000 (approx. USD2,538) per depositor per account and ₦200,000 (approx. USD1,015) per depositor per account for microfinance banks. There are two major sources of the fund:

internal and external. The internal sources consist of contributions (premiums) collected from the Islamic financial institutions (IFIs) and investment income from the Non-Interest Deposit Insurance Funds (NIDIF). The external sources consist of borrowing from the Government/CBN interest-free, and if it is interest based then it must be under extreme circumstances of necessity with funds raised from the Non-Interest Capital Markets (*sukuk*) and with special contributions, if the need arises, from insured Islamic financial institutions. The funds are segregated from the funds of the conventional deposit insurance.

The non-interest deposit insurance covers the following non-interest deposits: safe keeping deposit (*wadi'ah*), interest free deposit for investment (*qard*), profit sharing/loss bearing deposit (*mudarabah*), profit and loss sharing deposit (*musharakah*), and any non-interest deposit type that may be approved by the CBN from time to time. However, insider deposits, counter claims and interbank takings/borrowings are not covered by the scheme.

4.5.7. Human Capital & Knowledge Development Framework

The main challenge facing Islamic finance in Nigeria is the lack of adequate manpower. This challenge is evident at different levels ranging from the regulatory bodies, Islamic financial institutions, law firms, audit firms, etc. The regulatory bodies also have very few staff that possess the requisite qualifications/knowledge of Islamic finance. At the institutional level, the Bank Examiners have at various times identified the lack of adequate qualified personnel as a major challenge for Islamic banks/banking windows.

However, despite the daunting manpower challenge, two prominent universities (Bayero and Usman Danfodio) have vigorously embarked on Islamic economics/finance programmes at the postgraduate level. Particularly, the International Institute of Islamic Banking and Finance of Bayero University, established in 2011, which has as its mission as “extending the frontiers of knowledge of Islamic Banking and Finance nationally and internationally with enthusiasm, dedication and professionalism with a view to producing high quality human resources rich in entrepreneurial skills for the development of mankind”, actively engages in professional and postgraduate academic programmes and organizes annual international conferences on Islamic finance as a way of promoting the knowledge of Islamic finance.

Additionally, there are some initiatives in the private sector aimed at promoting Islamic finance in Nigeria. Metskills Limited, incorporated in 2009, offers advisory and consultancy services on *zakah*, Islamic economics, Islamic banking and finance, *waqf*, *takaful* and management strategies as well as collaborating with numerous local and international partners to offer training and skills acquisition on Islamic finance.

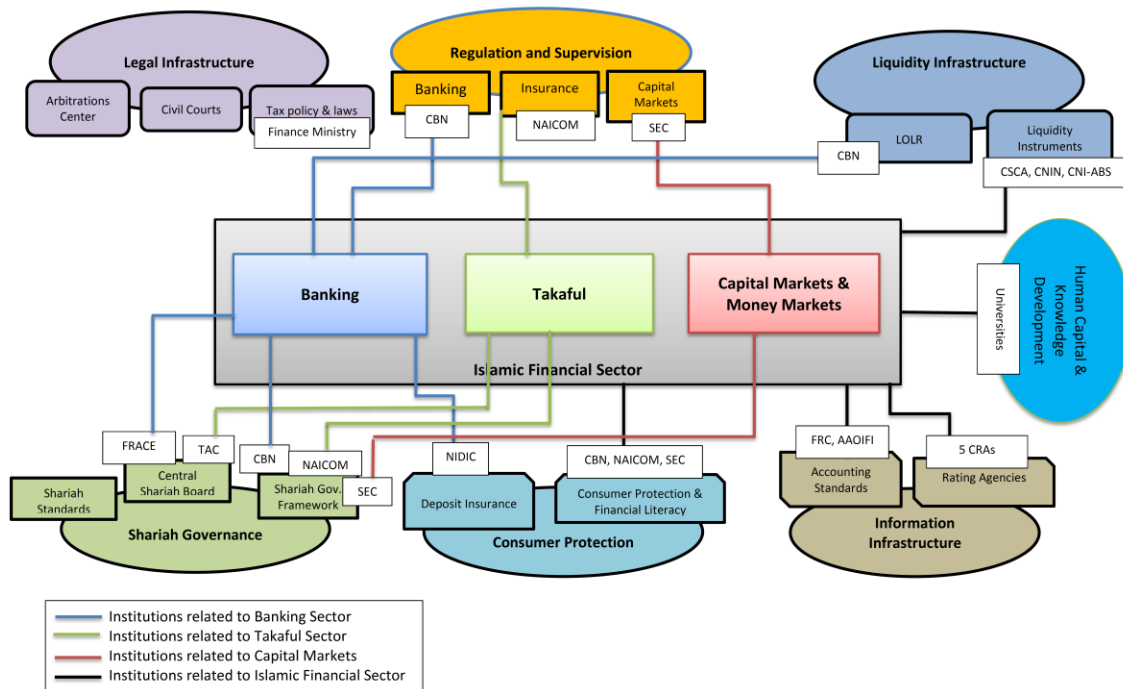
The CBN, in collaboration with the IFSB, have consistently organized capacity building workshops on IFSB standards in 2011, 2012, 2014 and 2016 for relevant stakeholders in the Islamic finance industry. Enhanced Financial Innovation and Access (EFInA, 2009), facilitated by the UK Islamic Finance Council (IFC), has established the Nigeria Islamic Finance Working Group (NIFWG) for the purpose of providing capacity building to regulators and operators.

4.5.8. Summary and Conclusions

The status of the infrastructure for Islamic finance in Nigeria is shown in Chart 4.4. The Islamic finance sub-sector is a new phenomenon on the Nigerian financial landscape and has high

prospects for growth. The sub-sector is, however, being challenged by a lack of adequate Islamic finance architecture. The legal environment is still not fully developed to effectively support the workings of Islamic finance. The legal system limits the ability of the regulatory bodies, such as the CBN to come up with robust liquidity management instruments thereby leaving the Islamic financial institutions in a disadvantageous position in managing their liquidity. Despite the challenge, the regulatory bodies were able to issue guidelines for the regulation and supervision of the institutions as well as *Shari'ah* governance standard. The regulators have embarked on an Islamic finance awareness campaign as a key component of their financial inclusion strategy. In partnership with the private sector, they have also initiated a number of capacity development programmes as a way of addressing the manpower challenge in the sub-sector. In conclusion, while much has been done, there is a need to further strengthen the legal environment to give a full backing to Islamic finance in Nigeria.

Chart 4.5: Islamic Financial Architecture Institutions—Nigeria



4.6. Oman

Oman opened up to Islamic finance with the passage of the Royal Decree 69/2012 issued on 6th December 2012. The Banking Law 2012 that amended the Banking Law 114/2000 allowed the opening of Islamic banks, Islamic windows and Islamic branches for foreign banks. Furthermore, the Royal Decree 59/2014 issued on 10th November 2014 modified the capital market law and authorizes a Capital Market Authority (CMA) to issue Sukuk regulations. In July 2013, the Muscat Securities Market (MSM) launched its Shari'a compliant index (TR et.al, 2015: 36) and the first sukuk was issued in the country on 3rd November 2015 (MSM). CMA, which also regulates the insurance industry, has issued a draft for Takaful Law that was approved by Royal Decree 11/2016 issued on 6th March 2016. By the end of 2015, there were 20 banks in the country, seven of which were local, nine were foreign, two were specialized, and two were Islamic banks (CBO, 2015:38). Furthermore, six conventional banks had Islamic windows and there were two *takaful* companies.²⁸

While Oman's first Islamic bank started operations in January 2013, the sector has grown rapidly both due to a sound legal and regulatory framework and also due to high pent-up demand. In a short period of time, Islamic banking assets rose to OMR 1.07 billion (USD 2.78 billion) accounting for 4.4% of the banking assets in June 2014 (TR et. al 2015). Total assets in Islamic banks and windows represent 7.4% of total assets in the banking sector in the last quarter of 2015, compared to 5.2% and 3.6% in 2014 and 2013 respectively (CBO, 2015). Moreover, it is expected that the total assets of Islamic banks and windows is to reach 10% of total assets in the banking sector by 2018 (TR et. al. 2015: 12). This rapid growth is remarkable when compared to other countries such as Indonesia where Islamic finance was initiated in 1992 and Islamic banking accounts to only 5% of the banking sector. According to the ICD-Thomson Reuters Islamic Finance Development Indicators, Oman's Islamic finance industry is the world's third most developed, behind Malaysia and Bahrain (TR et al. 2014: 9).

4.6.1. Legal Infrastructure

Supporting Islamic Finance Laws

The banking sector in Oman is governed by banking law and supervised by the Central Bank of Oman (CBO). As indicated, the Banking Law 114/2000 was amended by royal Decree 69/2012 issued on 6th December 2012. A new Chapter 6 entitled "Islamic Banking" was added to banking law making Islamic banking an integral part of banking law. The new chapter on Islamic banking has six articles providing the basic elements of a legal framework and leaving most of the details to regulations. Article 126 of the Banking Law strengthens the legal standing of Islamic banking stating "all that contradicts or contravenes the amendments set forth in the Islamic Banking Decree shall be revoked" (McMillen 2013: 4). Following the amendment of the banking law, CBO issued Islamic Banking Regulatory Framework (IBRF) to regulate Islamic Banks, Islamic Branches and Islamic Windows. In other words, a separate and

²⁸ The first fully-fledged Islamic bank is Bank Nizwa which opened in year 2012, and the second is AlAizz Bank which opened in year 2013. The six Islamic windows of the conventional banks are; Meethaq (Bank Muscat), Al Hilal (Ahli Bank), Muzn (National Bank of Oman), Maisarah (Bank Dhofar), Sohar Islamic (Bank Sohar) and Al Yusr (Oman Arab Bank). Two *takaful* companies are Al Madina insurance, Takaful Oman Insurance (CMA)

dedicated regulation (other than the regulation governing conventional banks) was issued to govern Islamic banks.

CMA was established by Royal Decree 80/98 issued on 9 November 1998 and commenced its duties on 9 January 1999. CMA has both regulatory and legislative roles (CMA 2016a). In its latter role, CMA prepared a draft law for *takaful* and its application mechanism in the country which was approved on 6th March 2016 (CMA 2016b). The draft of Takaful Law “complies with Takaful Standards issued by Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI)” and is in line with Bahrain and Qatar practices (TR et al 2015: 114). The Islamic Capital Market was added in the Capital Market Law by its amendment in Royal Decree 59/2014 issued on 10th November 2014. The amended Capital Market Law authorizes CMA to issue sukuk regulations. Currently, CMA has submitted sukuk regulations for review and approval.

Tax regimes and impact on Islamic Finance

Article 125 the Banking Law 2012 exempts Islamic banks from the imposition of fees levied on the transactions conducted on lands and movable property. Specifically the article exempts Islamic bank charges imposed by transactions involving ownership and leasing of movables and real estate overriding a number of other laws such as land and tax laws related to land transactions (McMillen 2013). This is in consideration of the unique structure of Islamic transactions and to ensure a level playing field. Furthermore, amendments are now in process on Income Tax Law 2008 to consider the unique features of sukuk.

Dispute Settlement/Conflict Resolution Framework and Institutions

The Commercial Court in Oman has jurisdiction over commercial disputes that include banking and finance. Other than settling disputes using Shariah, the courts apply Omani laws established by Royal Decrees (OSEC 2011). Disputes related to Islamic finance are dealt and adjudicated under the existing laws of the country and are not treated as other cases. Specifically, the courts apply the principles of Sharia on contractual sharia related to disputes in addition to the general rules of contract provided that these rules do not conflict with Sharia principles. Article 4 of the Banking Law provides for arbitration as dispute resolution in the commercial courts if agreed to by the parties concerned (BLO).

Bankruptcy and Resolution of Banks

Bankruptcy is dealt with and provided for in Commercial Law 55/90 in which the rights of the creditors and a detailed bankruptcy framework are covered. In addition, Article 85 of the Banking Law 114/2000 deals with bankruptcies of banking institutions. The Islamic banks are covered under these regimes with due consideration to the nature of the banking relationship with the Islamic banks’ customers that include depositors, investors or customers who are financed Islamic banks. Dissolution and liquidation of Islamic banks are covered in Section 8 of the Islamic Banking Regulatory Framework. Sukuk regulation under the final stages of approval also considers the bankruptcy of the issuer (CMA).

4.6.2. Financial System Regulation and Supervision Framework

Central Bank of Oman (CBO) is the regulatory body which supervises the banking sector in the country. After the amendment of Banking Law in 2012, CBO issued the Islamic Banking Regulatory Framework (IBRF) to organize and supervise the Islamic banking operations provided by Islamic banks, Islamic windows and branches. The IBRF contains licensing requirements, capital requirements, sharia governance components and requirements for fully-fledged Islamic banks and Islamic windows, accounting and auditing policies, risk management guidelines, liquidity management and relevant issues and guidelines. CBO has an Islamic Banking Department which deals with all the issues related to Islamic banks and windows.

IBRF provides details on the Sharia compliant instruments that can be used by Islamic banks and requires Islamic banks to inform CBO about any new Islamic banking products launched by the banks. Title 5 of IBRF provides details of Capital Adequacy requirements for Islamic banks. The document acknowledges that the Basel Committee capital requirement may not fully address the capital adequacy requirements for Islamic banks adequately and that the IFSB standards may be required. As Islamic finance is new in the country, there aren't adequate Sharia compliant instruments that can be used to meet the Basel III Tier 1 and Tier 2 capital requirements. Currently, there are no financial soundness indicators (FSIs) for Islamic banks in the country.

Islamic capital market and takaful/insurance are supervised by the Capital Market Authority (CMA). As indicated, while the Islamic capital market is covered by Capital Market Law, *takaful* law has been recently approved. Currently, CMA is working in Sukuk Regulations. CMA does not have a separate department to deal with Islamic capital market issues.

4.6.3. Shariah Governance Framework

While the Banking Law of 2012 requires financial institutions dealing with Islamic banking to have a Sharia supervisory board, the details of the functions of the board are outlined in the Islamic Banking Regulatory Framework (IBRF). Confirming Sharia governance framework as a requirement for licensing Islamic financial institutions (Islamic banks, takaful and Islamic capital markets institutions), IBRF provides details about Sharia governance and it talks about the Sharia Supervisory Board, Internal Sharia Reviewer, Sharia Compliance Unit and the Sharia Audit Unit. Article 2.2 (Sharia Supervisory Board) in Title 2 (General Obligations and Governance) in the IBRF provides details of the terms of reference for the Sharia Supervisory Boards (SSBs) with the following headings: Appointment and Composition; Rules and responsibilities of SSB; "Fit and Proper" criteria for the members of SSB; Terms of SSB; Diligence of the SSB member, conflict of interest, and change; Grounds for the disqualification of SSB members; and Management duties to the SSB.

While larger Islamic financial institutions should establish their own SSBs, smaller institutions can use an external Shariah advisory body subject to the approval of the Central Bank of Oman (CBO, 2012). SSB should have at least three Sharia scholars. Members of SSB should be independent and specialized in *Fiqh al-mu'amalat* (Islamic commercial jurisprudence). In addition, SSB can include one or more non-voting Muslim members who are not specialized in *fiqh al mu'amalat*. Members of SSB must have academic qualifications in the field of Sharia with experience of not less than 10 years. Furthermore, SSB members are appointed for a maximum

initial term of three years and can serve a maximum of two consecutive terms in an institution. Moreover, no SSB member can be on the SSB for more than one competing financial institution in Oman (CBO, 2012). The SSB is responsible for an overview of all Sharia related matters and must submit a Sharia compliance report to the Board of Directors which is also published in the annual report. The country requires Islamic financial institutions to use AAOIFI Sharia governance guidelines and IFSB's "Basic Professional Ethics and Conduct for Members of the Shari'a Board" from IFSB's Shari'a governance guidelines (IBRF 2012). However, the country does not require Islamic financial institutions to use AAOIFI Sharia standards although they are used as a reference.

Furthermore, Oman has a central national sharia board called the High Sharia Supervisory Authority (HSSA). In this regard, a regulation was issued by the Central Bank of Oman (Regulation NBM/REG/54/12/2013) announcing the formation of HSSA and its structure (CBO). Among its functions is providing opinions and expert advice on Sharia matters to the Central Bank of Oman related to Islamic banking business (CBO).

4.6.4. Liquidity Infrastructure

The issue of Liquidity risk management has been addressed in Title 9 (Liquidity Risk) of the Islamic Banking Regulatory Framework issued by the CBO. Islamic banks/windows are required under Central Bank of Oman instructions to have a comprehensive liquidity risk management framework in place and liquidity planning is an important facet of this framework. It should be explicitly incorporated during both normal and stressed times. Islamic banks/windows should adopt a liquidity management strategy with the involvement and periodic review of the Board of Directors and with senior management oversight.

Islamic banks/windows are required by regulations to maintain adequate liquidity to meet their obligations using a liquidity management framework that is compliant with Sharia (IBRF, 2012). For example, Islamic banks cannot place funds with conventional banks and Islamic windows cannot place funds with their parent bank. However, Islamic banks can receive money from conventional banks and Islamic windows from their conventional parent as long as the underlying contract is Sharia compliant (IBRF, 2012).

Different products can be used by Islamic banks/windows to operate in the Islamic Money Market. For example, Mudaraba Interbank Investment (MII) and Government Investment Issues (GII Sukuk) can be used (IBRF, 2012). Moreover, Islamic Banking Regulatory Framework (IBRF) provides relevant guidelines on interbank Mudaraba, interbank Musharaka and interbank wakala. While commodity murabaha is a widely used tool in the Islamic banking industry in many countries, its use is conditional and restricted in Oman. As the Islamic banking Sector is new in the country, the Central Bank of Oman is not offering any Sharia compliant liquidity management products or Islamic LLOR facilities to Islamic banks that can be used. The first OMR 250 million (USD 650 million at 3.5% cut-off yield) sovereign sukuk issued by the Government of Oman has addressed some of the liquidity management needs of Islamic banking institutions.

4.6.5. Information Infrastructure and Transparency

Accounting and Auditing framework/Transparency and Disclosure

Title 3 of the Islamic Banking Regulatory Framework provides details of the accounting standards, auditing framework, reporting, transparency and disclosure requirements to be adopted by Islamic banks, Islamic windows and Islamic branches of foreign banks. Islamic banks are required to follow Financial Accounting Standards (FAS) issued by AAOIFI and can use IFRS where AAOIFI standards are not available. Islamic windows/branches in the country are required to follow AAOIFI's accounting and auditing standards with the condition that the parent conventional bank would consolidate the financial statements using IFRS (CBO, 2012). Furthermore, external auditors are required to use AAOIFI's auditing standards and also standards on Auditing Assurance issued by IAASB where applicable (CBO, 2012).

All organizations in Oman are legally required to be transparent and disclose adequate information and there is a penalty for non-compliance. Islamic financial institutions are required by regulations to adopt AAOIFI and IFSB standards on transparency and disclosure. Moreover, Islamic banks, Islamic windows/branches in the country are required to prepare and submit the financial position and profit and loss account each year in accordance with AAOIFI standards (CBO, 2012). The sukuk regulation that is under the final stage of approval will deal with transparency and information that need to be disclosed in sukuk prospectuses (CMA).

Rating Agencies

CMA regulates ratings agencies in Oman. However, there is no registered rating agency in the country, so international ratings agencies provide credit ratings for financial institutions. However, there is no international ratings agency that provides *Shariah* rating of Islamic banks and *sukuk* structures in Oman as the market is still new and small.

4.6.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

Abiding by the Consumer Protection Law issued by Royal Decree 81/2002 and amended in 2014 by Royal Decree 66/2014, the public Authority of Consumer Protection (ACP) is very active in Oman. The law consists of five chapters and consumer rights are explained in chapter two. In case of unfair treatment at any time, consumers can call the hotline of Public Authority for Consumer Protection. They will answer immediately and guide them on how to solve the case. Members of Public Authority for Consumer Protection in the county are well trained.

Along with the Public Authority for Consumer Protection, customers of banks and financial institutions which are supervised by Central Bank of Oman (CBO) can reach the Customer Services Center at CBO in which their complaints will be registered and followed up with concerned department/organizations to resolve the case. Besides the Consumer Protection Law, IBRF covers consumer protection issues that are specific to Islamic financial institutions and institutions are encouraged to use IFSB guiding principles on Governance and Conduct of Business Standards used by regulators in Oman (IBRF 2012).

Customers of institutions listed in the capital market and insurance companies can approach CMA to redress any claims from companies. As a last resort, they can go to commercial courts which are specialized in this field. While there is no specific department or office dealing with customer complaints related to Islamic finance specifically, the current laws and institutions protect their rights also.

While all organizations by law are required to provide adequate information to customers before selling any goods or services (MOLA, 2014b), and customer rights are protected by Consumer Protection Law, there are no specific schemes for financial literacy for consumers in the country. However, almost all government institutions have websites which offer valuable information for consumers. For example, CMA, the regulator/supervisor of capital market and insurance companies enhances awareness in matters related to investments, the rights of investors, insurance for all the segments of the community through organizing conferences, workshops, and issuing booklets and awareness brochures (CMA, 2015).

Similarly, the Muscat Securities Market (MSM) seeks to encourage savings, disseminate investment awareness, and protect investors. It offers awareness publications in its website such as the Investment Book (MSM, 2012a) and useful investor links. In addition, the Central Bank of Oman (CBO) has uploaded its rules and regulation on its website such as Banking law and Islamic Banking Regulatory Framework. Also, customers of banks and financial institutions which are supervised and regulated by CBO can find a copy of CBO circulations in updated regulations and instructions addressing the above mentioned institutions. Furthermore, CBO publications such as the yearly report, financial stability report and the Al Markazi Magazine are available online. The government has also organized and hosted different conferences and seminars addressing different financial matters.

All Islamic banks and windows have website which offer details about their products and updated news. Their customers can contact them for more details. For example, the Meethaq Window offers services for customers to contact Sharia advisers and send their queries regarding Islamic finance. Furthermore, Bank Alaizz has a knowledge center in its website and Bank Nizwa has a section called “Know about Islamic Banking” which provides information to customers about Islamic banking and its history as well as how to differentiate between Islamic banking and conventional banking. Thus, while there are no specific financial literacy schemes, different organizations both public and private play active roles in enhancing the awareness of customers about the finance sector and Islamic finance in particular.

Deposit Insurance

The Bank Deposits Insurance Scheme (BDIS) was established in Oman on 1995 with the goal of reimbursing depositors in the event of a member bank's failure. The scheme is a part of Central Bank's safety net that is in place to protect the Sultanate's financial sector by protecting specific deposits of customers in the event of bank failure. It reimburses the depositors without any delay until their due is settled by the bank. The aim of the scheme is to enhance confidence in the banking system and to encourage a savings culture among the public.

All licensed banks accepting public deposits and operating within the country, except Islamic banks and Islamic windows, are members of the Banking Companies Ordinance (BDIS). BDIS protection is provided automatically to all depositors free of charge. It reimburses depositors up to a maximum of OMR 20,000 (USD 51,950). Deposits equal to or below OMR 20,000 (USD

51,950) are fully reimbursed. In addition, BDIS reimburses depositors on their net deposits per bank. In other words, the scheme reimburses per bank per depositor and joint account holders are treated separately according to their portion. PSIA holders of Islamic banks/windows are not covered by the BDIS. The Central Bank of Oman currently is working on a Sharia compliant insurance scheme for depositors of Islamic banking (CBO).

4.6.7. Human Capital & Knowledge Development Framework

Realizing that human capital is an essential building block for the development of societies and economies, the Omani government gives high priority to its development. Hence, it gives thousands of scholarships yearly for undergraduate and postgraduate studies based on the needs of the Omani labor market. In addition, it has a Research Council for innovation and development to satisfy the local needs and international trends.

As Islamic finance is new in Oman, having begun at the end of 2012, there is lack of adequate personnel in the country to cater to the needs of the Islamic financial sector at different levels. As a result, the government bodies support events that raise awareness of Islamic finance. For example, the Central Bank of Oman (CBO) has organized two conferences in Islamic Banking and Finance in 2012 and 2013. Furthermore, Islamic banks and windows in the country are legally required to train their employees at all levels (higher management, senior and junior staffs) and provide them with adequate information to deal with customers, and they are required to submit the list of Islamic banking training programs offered to the management, Shari'a resources and board of directors to the CBO annually (CBO, 2012).

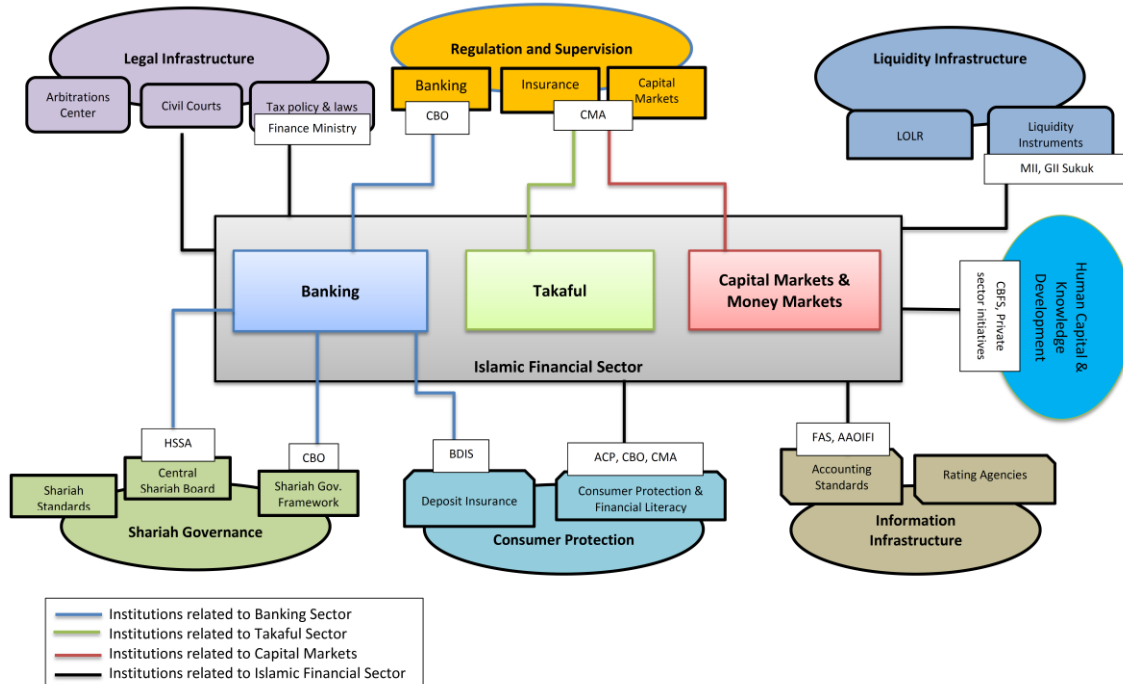
There are different educational institutions in the country offering short-term and long-term courses in banking and finance. The College of Banking and Financial Studies (CBFS), supported by the government and operating under the supervision of the Central Bank of Oman, has programs and courses to enhance the knowledge of and skills for the Islamic finance sector. Other than offering undergraduate degrees in Islamic finance, it has short training courses such as, Introduction to Islamic Banking, Islamic Banking Products, Financial Statements for Islamic Banks and Islamic Finance for SMEs. In addition, it offers preparatory training for Islamic Finance Qualification of CISI and preparatory training for CIMA Diploma in Islamic Finance.

There are also initiatives by the private sector to enhance the knowledge and skills on Islamic finance. For example, Meethaq Window (Bank Muscat) sponsored and hosted different events regarding Islamic finance such as the International Seminar on Risk Management and Compliance in Islamic Financial Institutions organized by the General Council for Islamic Banks and Financial Institutions (CIBAFI) (Meethaq, 2016) and a seminar that highlighted the core legal issues and risks in Islamic banking (Meethaq, 2014). In addition, Meethaq and Thomson Reuters are set to launch 'Meethaq Business Pulse', an innovative information portal targeted at promoting small and medium enterprise (SME) development in Oman (Meethaq, 2015). Similarly, Bank Nizwa provides a series of interactive workshops, training sessions, and conferences in strategic, leadership and Islamic banking disciplines to nurture the next generation of Islamic banking leaders (BN, 2016). Whereas Bank Nizwa organized the 2nd Islamic Banking Forum in Muscat (BN, 2014), Alizz Islamic Bank sponsored the 3rd Al Roya Economic Forum (AIB, 2014).

4.6.8. Summary and Conclusions

Although Oman started late in offering Islamic Banking and Takaful compared to other Gulf Cooperation Council (GCC) countries, it has a good start with a sound infrastructure. It has an advantage from the experience of GCC countries and their practices in Islamic finance. The government has shown an interest and given support to it during last three years that has resulted in rapid growth of the sector in the country. The legal and regulatory infrastructure for Islamic finance includes laws and regulations for Islamic banks, takaful companies and the Islamic capital market. In addition, the Central Bank of Oman (CBO) currently is working on an insurance scheme for depositors of Islamic banking and the Capital Market Authority (CMA) has prepared Sukuk Regulation which is in its final stage of approval. Also, there is a High Sharia Supervisory Authority (HSSA) which provides opinions and expert advice on Sharia matters to the CBO. The government of Oman has shown interest for continuous development of Islamic financial institutions and markets both on the demand and supply sides. Other than laws and regulation to support the industry, it has sponsored different training programs and hosted different conferences to raise awareness of the public. Along with government initiatives, Islamic banks and widows are also contributing to different educational events such as conferences, seminars and training programs to raise an awareness of Islamic banking and finance in the country.

Chart 4.6: Islamic Financial Architecture Institutions—Oman



4.7. Pakistan

Article 2 of the Constitution 1973 stipulates that Islam is the State Religion of Pakistan and Article 38 (f) mandates that the State eliminate *riba* from the economy. The constitutional institutions that work for promoting the Islamic system include the Council of Islamic Ideology (CII) (which is an advisory body), the Federal Shariat Court (FSC) and the Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan as an apex court to decide the appeals made against FSC judgments. Pakistan was among the first countries to initiate a transformation of the whole financial system in accordance with the principles of the Shariah. After the CII published a report on an interest-free economic system in 1980, the government took various steps to Islamize the economy (Husain undated; Minhas 2012). However, as the implementation of Islamic finance in Pakistan was not adequate, the Shariat Appellate Bench (SAB) in 1999 concluded that the financial system has to be subjected to radical changes to bring it into conformity with the Shariah.

The development of Islamic banking was renewed in 2002 taking a dual banking approach in which both conventional interest-based and Islamic banking co-exist. A comprehensive legal, regulatory and Shariah compliant framework was put in place. The main features of the regulatory approach of the State Bank of Pakistan (SBP), the regulator of the banking sector, are to promote Islamic banking on a sound and distinct footing, with consultations and collaboration with local and international stakeholders; and to also provide an enabling environment with regards to the legal, regulatory, supervisory, liquidity management framework, taxation regime and financial accounting & reporting framework. The Government instituted the 'Steering Committee for promotion of Islamic Banking' in 2013 to speed up work on Islamization. The Committee is headed by the Deputy Governor, SBP with representation from high level policy makers, bankers and the Shariah scholars associated with the banks. The Committee has reviewed the legal, regulatory and taxation frameworks and is working for development of an Islamic capital market.

The Islamic banking industry consists of Islamic banks, Islamic banking subsidiaries or the stand-alone Islamic banking divisions of the conventional banks (collectively called Islamic Banking Institutions IBIs). These have shown significant growth since 2002. The Islamic banking assets are valued at PKR 1511 billion constituting 11.2% share in overall banking assets in September 2015. As of September 2015, there were 5 dedicated/fully-fledged Islamic banks that had a combined network of 986 branches. Seventeen conventional banks had a network of 681 'stand-alone' Islamic branches and 116 sub-branches. The outreach of IBIs has also expanded and, as of September 2015, the branch network of IBIs consisted of 1,783 branches spread across 95 districts of the country (SBP 2015).

The insurance and non-banking financial institutions (NBFI) that includes different types of funds, asset management companies, real estate investment trusts, leasing companies, modaraba companies, and investment banks are under the regulatory purview of the Securities and Exchange Commission, Pakistan (SECP). A total of 5 takaful companies operate in Pakistan of which two offer 'Family Takaful'. Conventional Insurance companies have recently been allowed to open Takaful windows and they are in the process of preparations for offering takaful services in line with the framework introduced by the SECP. The IBIs are also offering banka-takaful policies (both family and investment) to their customers on behalf the takaful companies. The total Shariah complaints assets in the NBFI sector are PKR 204.44 billion (USD 1.95 billion) constituting 27.4% of the total in Feb 2016. The growth in Shariah compliant NBFI

sector in the recent past has been significant whereby it grew by 327.6% during June 2010 to Feb 2016 compared to growth of 59.7% for the conventional assets during the same period. There were 26 modaraba companies in the country with assets worth PKR 35.56 billion (USD 339.31 million) in February 2016 (SECP 2016). The total Shariah compliant mutual funds and pension funds in Feb 2016 were PKR 133.2 billion (USD 1.27 billion) and 6.353 billion (USD 60.62 million) accounting to 27% and 40% of the total respectively (SECP 2016). KSE Meezan Index (KMI-30) was launched in 2008 to track 30 Shariah-compliant companies.

4.7.1. Legal Infrastructure

Supporting Islamic Finance Laws

There is no separate act or law for Islamic banking and finance in Pakistan, and the Banking Companies Ordinance 1962 (BCO 1962) is applicable to both conventional and Islamic banks. However, after the report on interest-free economic system published by the Council of Islamic Ideology (CII) in 1980, the Banking and Financial Services (Amendment of Laws) Ordinance, 1984 (BFSO 1984) was introduced which amended the Banking Companies Ordinance 1962 along with several other laws such as the State Bank of Pakistan Act, 1956, Banking Companies (Recoveries of Loans) Act, 1979, The Negotiable Instruments Act, 1881, The Limitation Act, 1908 and the Code of Civil Procedures Act, 1908 to accommodate to the practice of Islamic banking in the country. Strategic Plan 2014-18 of SBP has initiatives to introduce further changes such as adding a separate chapter/part on Islamic banking in Banking Companies Ordinance 1962, making changes in SBP Act 1956, reviewing the Recovery of Finance Ordinance 2001, Microfinance Institutions Ordinance 2001, and any other related laws to further support the Islamic financial sector in the country.

There are various statutes, regulations and the guidelines that affect the capital market in addition to Circulars/Circular letters/regulations, rules, issued by the Securities and Exchange Commission, Pakistan (SECP). While the Insurance Ordinance 2000 identifies takaful as one form of insurance, details on the legal framework of takaful appears in Takaful Rules 2005 (SECP 2005). The Modaraba Ordinance 1980 also permits the issue of new interest-free instruments of corporate financing named Participation Term Certificate (PTC). While some general laws (such as Companies Ordinance 1984, REIT Regulations 2015; Guidelines for the Issue of Term Finance Certificates (TFCs) to General Public, Listed Companies [Prohibition of Insider Trading] Guidelines) affect both conventional and Islamic capital markets, there are some specific laws that affect the latter only. These include Government of Pakistan Ijara Sukuk Rules 2008, Sukuk Regulations 2015, and Guidelines for Issue of Certificate of Musharaka for Modarabas. Similarly, other than laws that affect both conventional and Islamic NBFIs (Guideline for Guidelines for Bancassurance 2010, The Banking Companies Ordinance 1962, Microfinance Institutions Ordinance 2001, The Financial Institutions (Recovery of Finances) Ordinance 2001), laws and regulations affecting the takaful and Islamic NBFIs include Takaful Rules 2005 Modaraba Companies and Modaraba (Floatation and Control) Ordinance 1980, Modaraba Companies and Modaraba Rules 1981, and Prudential Regulations for Modarabas, 2004 (amendment in 2008). The Securities Act of 2015 recognizes sukuk as one of the instruments of capital markets (SECP 2015).

Taxation policy for Islamic finance

Certain tax laws were amended in Pakistan to facilitate Islamic banking and to provide a level playing field. Instructions were issued to give equal status to Islamic financing documents in terms of stamp duties. These include Stamp Duty (Exemption) Order 1996; the Stamp Duty (Remission) (No 4) Order 1996; the Stamp Duty (Exemption) (No 6) Order 2003; the Stamp Duty (Exemption) (No 2) Order 2004; the Stamp Duty (Exemption) (No 3) Order 2004; and the Stamp Duty (Remission) Order 2004. Rule (3) of the 7th Schedule of the Income Tax Ordinance 2001(ITO 2001) (Finance Bill, 2009) provides an umbrella clause that discards any special treatment for 'Shariah Compliant Banking Company' approved by the SBP in terms of any reduction or addition to income and tax liability for the banks. Islamic banks are required to attach a certified statement to the return of income to disclose the comparative position of transaction as per the Islamic mode of financing and as per normal accounting principles (FBR 2011).

There are, however, still areas that require resolution for tax neutrality for the users of Islamic finance. Whereas tax facilitation has been done for *murabah*, issues related to other modes such as salam, istisna and ijarah are not dealt with. Going forward, the SBP plans to coordinate with the Federal Boards of Revenue (FBR) for the removal of tax anomalies, inconsistencies and achieving tax neutrality for Islamic banking institutions and also for users/customers of Islamic banking services. It also has a plan to coordinate with Federal and Provincial Governments/FBR for the exemption of property tax, stamp duties, etc related to Islamic modes of finance. Overall, the SBP has demonstrated resolve for developing the industry on a sound footing through enabling legal and regulatory regimes and partnering with the industry for addressing perception and taxation issues (SBP 2014).

Dispute Settlement/Conflict Resolution Framework

Except for the Federal Shariat Court (FSC) with the jurisdiction of a High Court, and the Shariat Appellate Bench (SAB) in the Supreme Court of Pakistan, there are no separate courts in Pakistan for Islamic banking and finance. The civil courts deal with Islamic banks and finance disputes. With regard to any conflict of opinion on any Shariah issue, the decisions of the SBP's Shariah Board are final for validity or otherwise of any transaction or proceedings in any courts.

As regards to the disputes relating to defaulted finance, banks—Islamic or conventional, and other financial institutions can sue the defaulters on the basis of the Financial Institutions (Recovery of Finances) Ordinance (FIO) 2001 that provides strong support to the banking companies to recover their financing/lending. An important provision of the FIO 2001 [Section 2 Clause (c)] is that the surety/guarantor falls under the definition of the customer, meaning that the creditors have the option to file suit against any of the principal debtors or the surety. This is in line with the AAOIFI's standard on Guaranties (3/3). Furthermore, Section 128 of 'The Contract Act, 1872' provides, "The liability of the surety is co-extensive with that of principal debtor, unless it is otherwise provided by the contract". Hence, the financial institutions are entitled to sue the Surety along with the principal debtor and the courts have been observing this provision of the law [2005 CLD 95 P.99 B; 2001 YLR 625].

As per the FIO 2001, the court can grant to banks the 'Cost of Funds' which is determined under Section 3 of this Ordinance. As per a ruling of the Division Bench of the Sind High

Court, awarding the cost of funds from the date of commission of default by the borrower/customer in fulfillment of obligation under subsection (2) of section 3 is mandatory [2009 CLD 312 (DB) P. 315 A]. However, the 'Cost of Funds' may be considered *riba* if not calculated on the basis of actual costs incurred by the Financial institution. Furthermore, the FIO 2001 does not differentiate between willful and non-willful defaulters meaning that every default is considered a willful default.

Bankruptcy and Resolution of Banks

As indicated, the Banking Companies Ordinance 1962 (BCO 1962) applies to both conventional and Islamic banks with the Banking and Financial Services (Amendment of Laws) Ordinance, 1984 (BFSO 1984) amending part of BCO 1962 to accommodate Islamic banking practices. Part III of the BCO 1962 deals with "Suspension of Business and winding up of Banking Companies" and Part IV covers "Special Provisions for Speedy Disposal of Winding up Proceedings". As the amendments in BFSO 1984 do not deal with these sections, the bankruptcy and resolutions procedures and processes of Islamic banks and conventional banks are similar.

4.7.2. Financial System Regulation and Supervision Framework

The regulations of the financial system in Pakistan are divided into two streams, one for the banks and the other for non-banking financial institutions (NBFIs) including investment or asset management companies. While all Islamic banking institutions (IBIs) operate under licenses from the SBP and are regulated/supervised by it, the *takaful* companies, mutual funds, investment banks, *Modarabas*, and Leasing Companies are regulated by the Securities and Exchange Commission, Pakistan (SECP). Both regulators have taken some steps not only to ensure stability of the system and Shariah compliance but to also safeguard the interests of the stakeholders.

The Islamic Banking Department was established in SBP in 2002 and is responsible for making and implementing policies for Islamic banking in the country in collaboration with other regulation and surveillance departments of the central bank. SBP issued the Banking Control Department (BCD) Circular No. 13 of 20th June 1984 that outlined 12 modes of Islamic banking which are still operative. SBP has also issued Guidelines Islamic Banking Windows in the conventional branches (IBD Circular No. 6, 2007). In addition to measures taken earlier since 2002, SBP issued detailed guidelines for Shariah compliance by the IBIs through IBD Circular No: 02 of 2008. These included, *inter alia*, Shariah Essentials of major modes, appointment and duties of Shariah advisors, conflict resolution in pronouncements, uses of charity funds, etc.

A fully-fledged Islamic Finance Department (IFD) was established in the Securities and Exchange Commission, Pakistan in December 2015. The Islamic Finance Department of the SECP is responsible for creating a Shari'ah regulatory environment and ensuring compliance by companies committed to undertaking their businesses and activities according to the principles of the Shari'ah. It is also mandated to issue, amend and enforce a Shari'ah compliant regulatory regime for the capital market including the non-banking finance companies (NBFCs), *takaful*, *modarabas* as well as non-financial companies. The focus areas of the IFD include developing a way forward for the Islamic Capital Market to ensure sustainable development and growth of Islamic finance in the country, developing a Shari'ah compliant index to promote investment culture in the Shari'ah compliant companies, and taking steps to ensure implementations of Islamic financial accounting standards and guidelines issued by the

international Islamic organizations and bodies to bring the level of Shari'ah compliance of the country on par with international standards. With a view to assisting the Mudaraba sector in resource mobilization, modarabas have been allowed to issue Musharaka based Term Finance Certificates on the basis of profit and loss sharing principles.

4.7.3. Shariah Governance Framework

The State Bank first issued a detailed set of instructions and guidelines for Shariah compliance and governance in the IBD Circular No. 2 of 2008. These instructions were revisited and a comprehensive Shariah Governance Framework (SGF 2015) was introduced in July 2015. The SGF 2015 provides for central Shariah Boards at the level of the State Bank of Pakistan and Shariah Boards (SB) in IBIs that include Islamic banks, Islamic banking subsidiaries or the Stand-alone Islamic banking divisions of the conventional banks. The Shariah Board at the State Bank of Pakistan comprises a minimum of 6 members – three Shariah scholars, one of whom is appointed as the Chairman, an accountant member, a lawyer member, and the Head of the SBP's Islamic Banking Department as Member-secretary and banker member.

At the bank level, the governance activities are to be performed by the BOD, Shariah Board, resident shariah board member (RSBM), Head Shariah Compliance Division (SCD), Head Shariah Compliance Department, In-charge Shariah Audit Department and In-charge Shariah Research/Review Department of the respective IBIs. The roles of internal and external auditors have also been defined. The BOD of each IBI must constitute a Shari'ah Board comprising at least three Shari'ah Scholars appointed as per the SBP's 'Fit and Proper Criteria' (FAPC) and must be subject to prior written approval of the SBP. The IBI, in consultation with the SB, can also engage professionals like lawyers, accountants, economists to act as SB members, but such non-Shariah scholar members shall not have voting rights in the SB meetings. The SB is expected to discharge its duties independently and objectively and the decisions/fatawa of the SB are binding on the Bank. In case of a disagreement between the SB and the management, the matter may be referred to the SBP. Every executive of the IBI shall ensure that all the procedure manuals, product programs, checklist etc as approved by the SB, are made available to and understood by everyone working in his/her respective group/functional area.

All the decisions/rulings/fatawa of SB shall be in conformity with the directives, regulations, instructions and guidelines issued by SBP in accordance with the regulations of SBP's Shariah Board. IBI's Shariah Board are required to implement the pronouncements of the SBP's Shariah Board and its members may not have their own opinion or discretion in any specific issues. The SB should prepare a report on the Bank's Shariah compliance environment and conditions based on the work of internal Shariah audit, external Shariah audit and Shariah compliance review. The report should be discussed in the BOD meeting and published in the Bank's annual report.

As per IBD Circular No 1 of 2010 and Circular Nos. 1 and 3 of 2013, SBP adopted several AAOIFI Shariah Standards with some clarification and/or amendments. Some of the standards include Standard No.3 (Default in payment by the debtor) with one amendment; Standard No.8 (Murabaha to Purchase orderer) with seven amendments; Standard No.9 (Ijarah and Ijarah Muntahia bil Tamleek) with four amendments; Standard No.13 (Mudaraba) for financing adopted without any amendment; Standard No 17 on Investment Sukuk with 15

clarifications/amendments; and Standard No 12 on Shirka / Musharaka / modern corporations with about a dozen clarifications/amendments.

Similarly, a four member Shariah board exists in the SECP consisting of prominent scholars and a representative of the SECP (SECP A.R; 2015). The Board advises the SECP on the operations, auditing and reporting of Islamic mutual funds, pensions and takaful operators etc. There are regulatory requirements to have a Shariah board in takaful companies and takaful windows of the insurance companies for the issuance of sukuk and for the fund management business. The SECP has also adapted the AAOIFI Sharia Standards Nos 3, 8, 9 and 13 with some amendments via a notification (SRO 45 of 2016). (SECP 2016b)

4.7.4. Liquidity Infrastructure

The Statutory Liquidity Requirements (SLR) for IBIs is the same as conventional banks as in June 03 2011. The State Bank of Pakistan revised the definition of Time and Demand Liabilities in August 2007 to exclude deposits with a tenor of less than one year from time liabilities and included the same in demand liabilities. IBIs may create treasury pools for interbank transactions through necessary authorization levels as defined in the pool management framework. Such pools, however, need to be maintained separately due to the peculiar nature of short term liquidity placements by the banks.

SBP's strategy document for Islamic finance envisages working on providing multiple liquidity management solutions for the industry by, among others, developing interbank market and an Islamic discount window (SBP 2014). In this regard, Shariah compliant Open Market Operations (OMOs) utilizing Ijara sukuk (Bai Muajjal of Sukuk) was introduced during 2015. Similarly GOP has also purchased Ijara Sukuk from the Islamic banking industry on deferred payment basis (SBP 2015b). To further encourage Islamic Financial Products, GoP announced Sukuks issued by Karachi Shipyard and Engineering Works (KSEW), WAPDA, Lahore Electricity Supply Corporation (LESCO) and National Industrial Parks Management Company as SLR eligible (SBP 2007-08). There is a LLOR facility for Islamic banks that has been under review for further improvement in 2015 (Iqbal 2015).

4.7.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency and Disclosure

For development of the Accounting Standards for Islamic Modes of Financing, a committee was formed by the Institute of Chartered Accountants Pakistan (ICAP) in 2005. This committee reviewed the AAOIFI's accounting standards with a view to adapt them to Pakistani circumstances and, if considered necessary, to propose new accounting standards. So far, IFAS -1, IFAS -2 and IFAS-3 have been developed for the financial reporting of Murabaha, Ijarah and Mudaraba for investment deposits respectively. For all other modes IFRS is used.

The IBIs have to ensure transparency with regard to calculation and distribution of profits among the depositors. IBIs are required to perform disclosure on their websites and notify the board of each branch regarding the profit sharing ratio (PSR), weightages assigned to each category of deposits, profit equalizing reserves (PER) and investment risk reserves (IRR), and the actual periodic profit/loss distributed to each category of deposits for the period concerned in at least two of the previous periods/years. The disclosures made in Notes to

Financial Statements include: the number and nature of pools maintained by the IBI along with their key features and risk and reward characteristics; avenues/sectors of economy where *mudarabah* based deposits have been deployed; parameters used for allocation of profit, charging expenses and provisions etc. along with a brief description of their major components; *Mudārib* Share (in amount and percentage of distributable income); amount and percentage of *mudārib* share transferred to the depositors through *hiba* (if any); and profit rate earned vs. profit rate distributed to the depositors during the year.

Rating Agencies

SBP promotes self-discipline in the financial markets of Pakistan through transparency and sufficient disclosure by the market participants. All banks/DFIs were required to get themselves credit rated with effect from June 30, 2001. Specifically, banks are required to have themselves rated by credit rating agencies approved by SBP and disclose their credit rating prominently in their published annual and quarterly financial statements. Accordingly, banks/DFIs continuously get themselves credit rated from credit rating agencies on the panel of SBP and the rating is updated yearly within six months from the closing date of each financial year.

Both short and long term ratings are made for all banks including Islamic banks and financial institutions. Banks and DFIs registered in Pakistan are mainly rated by Pakistan Credit Rating Agency Limited (PACRA) and JCR-VIS while the foreign banks operating in Pakistan are rated by Standard & Poor's, Moody's, FITCH and JCR-VIS. Most of the banks/DFIs have already made their credit rating public through print media and SBP has also compiled their ratings for the benefit of the stakeholders.

It is obligatory for asset management companies to get the unit trust schemes that they manage rated by a rating agency registered with the SECP. Management companies are also required to widely disseminate ratings of their funds so that institutional as well as individual investors may make informed decisions.

4.7.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

The two principal financial regulators, SBP and SECP, have a primary responsibility to regulate and supervise both prudential matters and market conducts in their respective areas. In the banking sector, two main entities responsible for implementing, overseeing, and enforcing consumer protection with respect to banking products and services are SBP (notably but not exclusively, the Consumer Protection Department) and the Office of the Banking Mohtasib (OBM). The SBP has issued regulations and directives to banks covering key aspects of consumer protection including disclosure, business conduct and dispute resolution. It has also laid out an ambitious agenda for further strengthening consumer protection in its 10-Year Strategy for Banking Sector Reforms. (WB 2014, Vol. 2)

The SBP Act, 1956 and the Banking Companies Ordinance 1962 (Section 27) provides broad powers to the SBP for protecting consumers. SBP should take necessary steps in the public interest and to prevent any affairs that are detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company. SBP has used these powers

extensively in recent years to issue secondary legislation, rules, regulations, and other directives to banks on consumer protection matters.

Further, SBP monitors consumer protection practices on an ongoing basis and also receives consumer complaints directly from the public, occasionally leading to issuance of further clarifications of regulations in force and standards expected of the financial sector. SBP regularly engages in consumer awareness campaigns in collaboration with foreign and local partners. Banks also undertake such activities according to their own business plans and programs. In the case of branchless banking, the draft guidelines outline minimum requirements for consumer awareness to be conducted by banks.

The Office of the Banking Mohtasib, or banking ombudsman, is an independent statutory body established by law to resolve disputes between consumers and banks. It is the first authority where a consumer, if not satisfied with a bank's decision, can lodge a complaint. It also collects, analyzes, and publishes data on consumer protection inquiries and disputes. The services performed by the ombudsman are free of charge. As is the case in some other countries, banks share the costs of the institution, with the cost to each bank determined by the central bank.

The SECP has a strong statutory mandate to protect investor and consumer rights and interests in the insurance and securities sectors, but needs to step up its supervisory and enforcement capacity to deal with noncompliance and malpractices in both market segments. There is a need to establish an effective coordination mechanism among regulators and the other key stakeholders, including the Competition Commission of Pakistan (CCP), industry associations, ombudsmen, and provincial consumer protection councils to define strategic priorities and clarify roles and responsibilities. With regard to the Banca takaful, SBP's BPRD Circular No. 11 dated August 1, 2006 requires banks to obtain prior consent from the existing or prospective customers for availing any insurance or other product or service. Furthermore, the Competition Act 2007, Section 3, prohibits tie-ins when they prevent, restrict, reduce, or distort competition.

Lately, both regulators have recognized the importance of financial education and have initiated programs to address the gaps. While the SBP is running special move to enhance awareness and education about Islamic banking and finance, the SECP has initiated '*Jama Poonji*' a program to educate investors about safe investments in the capital markets.

According to the WB report (2014), however, the judicial system in Pakistan does not currently ensure affordable, timely, and professional resolution of consumer protection disputes. The institutional framework for financial consumer protection is fragmented, and has important gaps and overlaps that have to be addressed either by the financial sector itself or through the establishment of a common financial ombudsman.

Deposit Insurance/Protection

No special law on deposit insurance exists in Pakistan. A draft law establishing an explicit deposit protection scheme (DPS) to provide protection to small depositors was drafted some time ago but has not been submitted to parliament (WB 2014, p.43). Under the Banks (Nationalization) Act, 1974, all bank deposits are protected by the government. However, the provision is no longer appropriate in a system that is largely privately owned except for the

NBP and some other banks. It is also not clear that the GOP would be in a position to honor this guarantee in a timely and orderly manner in the event of a failure of one or more large banks.

However, the State Bank Act provides SBP with a wide range of corrective measures in the event a bank conducts operations without due regard to safety and soundness or fails to comply with the Banking Companies Ordinance and SBP's Prudential Regulations. In recent years, SBP has successfully acted to resolve a number of smaller distressed banks using a variety of the methods available. If offsite surveillance or onsite inspection indicate signs of widespread weaknesses and the affairs of any banking company being conducted in a manner are detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, the State Bank, under the terms of Section 41 of the Banking Companies Ordinance, can remove and supersede the board of directors.

Banks are required to have their financial Diagnostic Review of Consumer Protection and Financial Literacy statements audited by external auditors on the panel maintained by the State Bank for the purposes of auditing banking companies under Section 35 of the Banking Companies Ordinance and submit them to the State Bank. Submission of wrong or misleading information leads to action against banks and auditors under the provisions of the Banking Companies Ordinance.

4.7.7. Human Capital & Knowledge Development Framework

To cater to the developmental needs of potential and existing workforce in Islamic banking, SBP launched in 2005 a three weeks rigorous Islamic Banking Certification Course at National Institute of Banking & Finance (NIBAF), training arm of the SBP. The course is aimed at building the capacity of bankers to deliver Islamic banking products and services, and, so far, over 35 batches of professional bankers have been certified. Keeping in view its relevance and importance in enhancing the capabilities of the banks' incumbents, it is now being offered to bankers from other countries as well.

SBP conducted a survey based study; "Knowledge, Attitude and Practices of Islamic Finance in Pakistan (KAP)" during 2015. According to the study there is an overwhelming demand for Islamic banking in Pakistan by both retail and corporate sectors. The Islamic banking industry in Pakistan, in collaboration with SBP, has been running a mass media campaign for the promotion of Islamic banking. After the successful launch of the first phase in 2013, a second phase was launched in December 2014 which focused more on education, awareness, and improving the understanding of Islamic banking and finance. The second phase involved advertisements in newspapers, radio and the distribution of brochures and placement of roll-up standees in IBIs' branches.

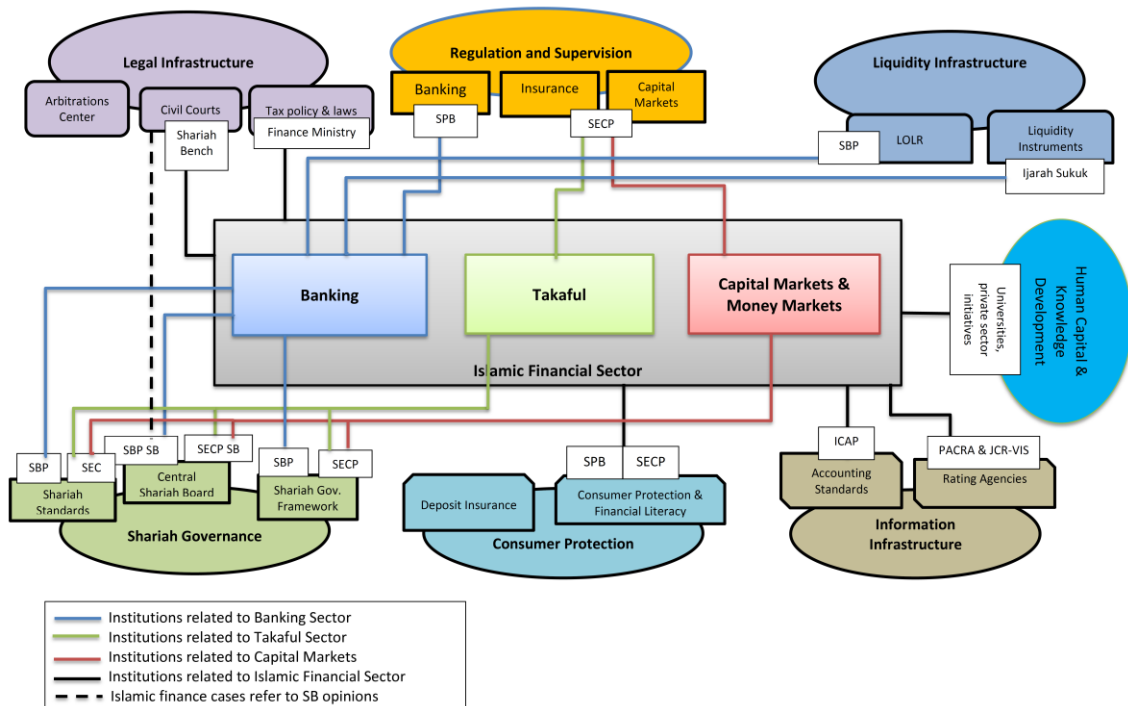
In order to ensure the adequate supply of trained human resource to the industry, SBP in collaboration with GOP, Industry and other stakeholders through support of the Department for International Development (DFID) U.K has established, in the third phase, three Centers of Excellence for Islamic Banking and Finance Education (CEIFEs) in three universities. The centers will have comprehensive set of educational and training programs for various audience groups, state of the art research facilities, and would provide good a knowledge environment. Under this initiative, the grantee institutions will perform a wide range of activities including setting-up exclusive Islamic Finance education and research infrastructure, curriculum

development, international collaborations, industry linkages, and, most importantly, they will attract private investments for ensuring the sustainability of the initiative.

4.7.8. Summary and Conclusions

A comprehensive regulatory and supervisory framework has been provided to the Islamic financial institutions in Pakistan with focus to ensure Shariah compliance. The Shariah Governance Framework ensures Shariah compliance, improving transparency and bringing standardization in the IBIs' practices while taking care for stability of the system. The areas where efforts need to be put in are providing special laws and regulation, and tax neutrality facilitating the IBIs to undertake business in line with the Shariah principles in letter and spirit. Currently there is no code of conduct for banks in Pakistan. SBP's (2009) 10-year strategy has planned to encourage the Pakistan Banks' Association (PBA) to adopt a Banking Code of Ethics, which could be used as a basis for committing all banks to fairness, disclosure, and proper ethical standards. Generally sound grievance and redress mechanisms exist in Pakistan for bank customers, but their effectiveness could be enhanced by increasing awareness of the process and streamlining procedures. The government and the regulators also need to take care of the social and distributive impacts of the banking and monetary practices.

Chart 4.7: Islamic Financial Architecture Institutions—Pakistan



4.8. Saudi Arabia

The legal system of Saudi Arabia is based on Shariah principles and the Quran and Sunnah which form one of the essential pillars of Saudi Arabian law-making²⁹. A total of 12 banks and 12 branches of foreign banks represent a mixture of Islamic and conventional business in Saudi Arabia. The country is considered as one of the largest markets for Islamic banking and finance in the world. The total Islamic banking assets were valued at USD 291 billion accounting for 51.2% of the total banking assets in the country and 33% globally (EY 2016).

The Saudi insurance sector has a relatively a short history as a formally structured, regulated and supervised industry. Prior to the passage of the Law on the Supervision of Cooperative Insurance Companies (the Insurance Law) in 2003 and the Insurance Implementation Regulations in early 2004, the insurance sector consisted of one state-owned company (currently known as Tawuniya) (Saudi Arabian Monetary Agency, 2015). Now there are more than 220 licensed companies that include insurance and reinsurance companies, insurance brokers and agents, actuaries, loss assessors, adjusters, insurance claims settlement specialists (third party administrators) and insurance advisors. The takaful insurance represents part of the Islamic finance industry in Saudi Arabia which is served by more than 35 cooperative insurance providers. In 2014, the total takaful/retakaful assets in the country were the largest globally standing at USD 12.38 billion constituting 37.1% of the global assets of USD 33.39 billion (ICD and TR 2015: 18).

Saudi Arabia is host to the largest market in asset management with a total of 169 funds worth of USD 22.90 billion managed in the country in 2014 (TR 2016: 27). The value of the outstanding sukuk in the country during the year was USD 46.89 billion constituting 15.9% of the global outstanding sukuk valued at USD 295.094 billion (ICD and TR 2015: 19).

4.8.1. Legal Infrastructure

Supporting Islamic Finance Laws

The Banking Control Law issued under Royal Decree No. M/5 dated 11/6/1966 (BCL 1966) is considered the main legislation to regulate all banking and financial services in Saudi Arabia. This law gives the Saudi Arabian Monetary Agency (SAMA) broad powers to regulate and supervise Saudi banks and to safeguard the banking system. In line with Article 2 of the Royal decree, the charter of the SAMA, the SAMA acts as the central bank and is banned from engaging in business based on interest. All banks come under the control of the traditional control system. The Banking Control Law is considered the main legislation to regulate all banking and financial services in Saudi Arabia. It defines the banking business, confers licensing powers, and determines capital adequacy, opening of current accounts, opening of letters of credit, issuance of letters of guarantee, payment and collection of cheques, payment orders, promissory notes and similar other papers of value, discounting of bills, bills of exchange and other commercial papers, foreign exchange transactions and other banking business. Being a traditional banking law, Article 10 of Banking Control Law defines baking

²⁹According to The Constitution of the Kingdom of Saudi Arabia "The Kingdom of Saudi Arabia is a sovereign Arab Islamic state with Islam as its religion; God's Book and the Sunnah of His Prophet; God's prayers and peace be upon him are its constitution...".

business in a conventional way. Saudi Arabia does not have independent laws to deal with Islamic banks.

Art 2 of the Royal decree No.23 Dated 15/12/1957 established the charter of SAMA says “The Saudi Arabian Monetary Agency shall not pay nor receive interest, but it shall only charge certain fees on services rendered to the public and to the Government, in order to cover the Agency's expenditures. Such fees shall be charged in accordance with a regulation passed by the Board of Directors and approved by the Minister of Finance”. SAMA also regulates the cooperative insurance companies sector in Saudi Arabia. The Law on Supervision of Cooperative Insurance Companies (LSCIC 2003) was approved by Royal Decree no. M/32 dated 01/08/2003 which set the stage for the legal framework of the cooperative insurance companies sector in Saudi Arabia. LSCIC articulates in Art 1 that offering insurance services should be in accordance with the principles of Islamic law. The cooperative insurance law and its implementing regulations give SAMA wide-ranging powers such as the licensing, regulating and supervising of the insurance sector.

Beside SAMA being the principal regulator of the insurance market, there are other regulatory authorities involved. Article 1 of the Law on Supervision of Cooperative Insurance Companies (LSCIC) states “Insurance in the Kingdom shall be undertaken through registered insurance companies operating in a cooperative manner as it is provided within the article establishment of the National Company for Cooperative Insurance promulgated by Royal Decree M/5 dated 17/5/1405 H, and in accordance with the principles of Islamic Shari’a”. The Council of Cooperative Health Insurance shares the responsibility of supervising the medical insurance line, providing continuous technical and medical follow-up to all those concerned with the system, and supporting the ongoing efforts to preserve the rights of all insured. Similarly, Capital Markets Authority (CMA) is mandated to ensure that all insurance companies are compliant with the Saudi Capital Market Law (SAMA 2015).

In addition to the responsibility of SAMA towards the banking and insurance, it is entrusted with regulating and supervising the real estate financing company and finance companies under the Finance Companies Control Law 2012 (FCCL 2012) (SAMA 2016b). Article 2 of FCCL asserts that finance companies licensed under the law should engage in finance activities in a manner not conflicting with the principles of the Sharia as defined by Sharia committees. Article 3 of FCCL stipulates that companies engaging in finance activities should observe the principles of Shariah that are agreed upon by the selected Shariah Committee by the company. SAMA's market restructuring initiative resulted in a significant development of the non-bank financing sector. SAMA has licensed a number of banks, real estate finance companies and other finance companies that would carry out one or more finance activities according to its list or approval activities. Under this law SAMA can exempt banks being banned from carrying out real estate financing.

The Capital Market Law 2003 (CML 2003) issued by Royal Decree No. M/30 dated 2 July 2003 governs the capital markets activities in Saudi Arabia. While sukuk is regulated and governed by CMA under the code ‘Offers of Securities Regulations’, no specific attention is given to it as a Shariah compliant product. In fact, the rules mainly cover the procedures for issuing securities rather than focusing on their form and type. The CMA regulates sukuk and bonds and both are subject to the same rules and principles.

Tax Regimes and Impact on Islamic Finance

Income tax laws are governed by Royal Decree No. 17/2/28/3321 dated 2/11/1950 and amended by Royal Decree No 17/2/28/576 on 19/10/1956. Most laws on banking and finance refer to the Department of Zakat and Income Tax (DZIT) as the highest authority on supervising and imposing the zakat and tax. DZIT is responsible for calculating the relevant zakat payments required from banks and financial institutions (King and Spalding, 2013). While there is differentiation between the Saudi individual/company and a non-Saudi individual/capital company for applications for the zakat and tax, whereby the latter is not subject to income tax on salaries, there is no reference to activities related to Islamic or non-Islamic businesses. Thus, Islamic financial institutions are taxed similar to their conventional counterparts.

Specific laws and regulations related to different financial activities recognize obligations to pay zakat and taxes and the role of DZIT. For example, the Law on Supervision of Cooperative Insurance Company (SCIC) issued by Royal Decree No.32 Dated on 2/6/1424H stipulates that all insurance and re-insurance companies shall submit to the DZIT their zakat or tax returns in accordance with the rules and implementing regulations. In addition, Finance Company Control Law 2012 (FCCL 2102) states that the DZIT should issue the necessary criteria for calculating Zakat for finance companies.

SAMA has been more active in the market by eliminating high fees or taxes that affect capital markets. Chapter 3 under the Real Estate Finance Law 2012 dealing with Secondary Market of Real Estate stipulates that mortgage transfer procedure in the secondary markets are relieved from registration fees stipulated in the Real Estate Registration Law. In addition, the law provides the Council of Ministers with the ability to grant tax incentives for securities issued with respect to real estate financing.

Dispute Settlement/Conflict Resolution Framework and Institutions

The legal system in Saudi Arabia is considered a dual judicial system. The Saudi judicial system was reformed by the new law of judiciary promulgated by Royal Decree No. M/78 on 19/09/1428H. It consists of two laws: the Law of the Judiciary and the Law of the Board of Grievances. In principle, the courts has jurisdiction over most traditional judicial matters in Saudi Arabia in accordance with their jurisdictions. Nevertheless, there are a number of quasi-judicial courts which have jurisdiction in certain cases. These committees have an exclusive jurisdiction in certain cases outside the scope of competence of the Shariah court. These include the Banking Disputes Settlement Committee (BDSC), the Committee for the Resolution of Securities Disputes (CRSD) under the Saudi Capital Markets Authority (CMA), the Committee for the Resolution of Financing Violations and Disputes (CRFVD) to hear disputes under the Finance Companies Control Law (FCCL) and the Financing Lease Law (FLL) and Insurance Dispute Committee (IDC). Essentially, these are administrative committees with judicial powers. Some of them have been established in response to Shariah Court judges' unwillingness to entertain cases based on interest claims (Al-Jarbou 2004).

Though Saudi commercial banks were allowed to develop interest-bearing arrangements, no government body has been competent enough to make an official ruling regarding interest payments. 'Interest' in Saudi Arabia is frequently recorded as 'special commission income', 'service charges' or 'book-keeping fees' (Wilson, 1991). Thus, the Royal Order 729/8

established the SAMA Committee in 1987 for resolving legal issues relating to banking disputes. The establishment of the Banking Disputes Settlement Committee as an arguably judicial body has since, in one way or another, avoided a confrontation with the question of the legality of interest under Islamic Law.

In addition, the jurisdictions of these administrative committees are limited. For example, SAMA is limited, according to Royal Order No 4/110 of 1988, to only covering disputes concerning, for instance, letters of credit, various types of accounts, loans, and other purely banking business activities. Its jurisdiction over banking disputes is exclusive, and at least one party to the dispute must be a bank, whether foreign or national, and the nature of the bank must fall within the term 'banking business' as defined in Article 1 (b) of the Banking Control Law (BCL). Thus, non-banking activities involving banks are subject to the jurisdiction of courts and tribunals.

Both committees established under both Finance Companies Control Law (FCCL) and LSCIC are new and no precedent cases have been presented recently. However, the Banking Disputes Settlement Committee established under SAMA has been for a long time. In theory, the SAMA Committee is obliged to apply the Shariah and its precepts to banking disputes, including the prohibition of interest. However, in practice, the SAMA Committee has generally shown a willingness to force recalcitrant debtors to honour the terms of their agreements which create indebtedness, regardless of whether or not the agreement required the payment of monies in the form of interest. It examines the various relevant documents and inquires if these arrangements are in accordance with Saudi Arabian law. It will, however, take all reasonable efforts to respect the agreement of the parties, even in the face of conflicts with the Shariah (McMillen, 2000).

In terms of alternative dispute resolution, the Law of Arbitration issued by Royal Decree No M/34, dated 24/5/1433 AH, has been improved and considers Shariah law as a corner stone when issuing the decision. Also, there is the Saudi Center for Commercial Arbitration (SCCA) established under the Council of Saudi Chambers.

Bankruptcy and Resolution of Banks

A separate insolvency and resolution framework for banks do not exist in Saudi Arabia (FSB 2105). The existence of Saudi insolvency comprises two statutory provisions: The Commercial Court Law (CCL) issued by Royal Decree No. (M/2) Dated 15/1/1390H embeds clauses under Chapter 10 to deal with insolvency cases and Royal Decree M/16 of 1416 deals with the Law of Settlement Preventing Bankruptcy (LSPB). Both laws are applied on Banks, Finance and Insurance companies. Recently, the regulator is working to introduce a new Insolvency Law and has released the insolvency Law Policy (Ministry of Commerce and Industry). SAMA has also interpreted Article 22 of Banking Control Law 1966 to deal with failing banks by either merging a troubled institution with a sound bank or by shareholder recapitalization (FSB 2015).

According to a report issued by the World Bank, Saudi Arabia has reported a very low usage of bankruptcy law systems (Uttamchandani, 2011). Furthermore, the insolvency laws are mainly not compliant with international standards nor are they considered particularly effective by the users. (Uttamchandani, 2011).

4.8.2. Financial System Regulation and Supervision Framework

In Saudi Arabia, there are two authorities responsible for the regulation and supervision of Islamic banking and financial activities, cooperative insurance (*takaful*), and sukuk. These authorities are the Saudi Arabian Monetary Agency (SAMA), and the Capital Market Authority (CMA). Under the authority given by BCL 1966, SAMA regulates and supervises Islamic financial institutions (IFIs) that conduct banking and financial activities along with conventional commercial banking businesses.

SAMA the central bank of the Kingdom of Saudi Arabia has been entrusted with performing many functions pursuant to several laws and regulations. The most important functions, relating to our subject matter, are promoting the growth of the financial system and ensuring its soundness; supervising commercial banks; supervising cooperative insurance companies; and supervising finance companies.

Islamic banks are not considered different from conventional within the framework of SAMA and are regulated in the same way (BCBS 2015: 34). This applies to the operational efficiency, risks and resilience of banks. Nevertheless, the assessment could be changed if there were great varieties of Shariah complaint activities and the financial reporting standards applied to Shariah complaint activities (BCBS 2015). BCBS (2015) suggests doing a practical assessment as to whether the applications of Basel Committee standards cover the risk stream from Shariah complaint banks and activities (BCBS 2015).

Further, according to the Finance Companies Control Law (FCCL), SAMA has the supervision on finance companies licensed in accordance with the provisions. It has no special reference to Islamic finance with the Law apart from in Art 1 by confining that engaging in financing activities should be in line with the Shariah law. Also, the Law on Supervision of Cooperative Insurance Companies (LSCIC) stipulated in Art 1 insurance are to be undertaken in accordance with Shariah.

Furthermore, the non-bank private financing sector has undergone major restructuring. The Finance Companies Control Law (FCCL) and its Implementing Regulations aim to form a new competitive sector to extend credit while facilitating its soundness and stability. The Law and its Implementing Regulations envisage provisions that regulate the licensing of companies and set requirements/standards with respect to capital adequacy, finance policies and measures, exposure limits, internal organization, corporate governance, risk management, internal audit, compliance and refinancing. These requirements are intended to contribute to enhancing the stability of the sector, maintaining its soundness, and promoting the level of credit activity with better risk management (SAMA 2015). These are, supposedly in line with Shariah Law. All these developments in the financial system show emerging acceptance to Shariah principles, although there is no distinction between conventional and Islamic finance.

The Capital Markets Authority (CMA) was established under Article 4 of the Capital Market Law (CML) 2003 to regulate and develop the Saudi capital markets by issuing the required regulations and rules for implementing the provisions of CML. In addition, the CMA regulates the issuance of securities and monitors securities and dealing in Securities including the issuance of sukuk. It also regulates and monitors the work and activities of parties subject to the control and supervision of the Authority.

4.8.3. Shariah Related Issues and Governance Framework

Within the context of the official company structure in Saudi Arabia, the Shariah Supervisory Body (SSB) is not recognised by either Saudi Arabian Monetary Agency (SAMA) or the Capital Market Authority (CMA). Among the laws, only the Finance Companies Control Law stipulates that companies engaging in finance activities should observe the principles of Shariah that are agreed upon by the selected Shariah Committee by the company. However, there are no specific rules or regulations pertaining to SSB. Issues related to SSBs are left to individual IFIs and their roles and responsibilities are subject to the decisions of the management.

4.8.4. Liquidity Infrastructure

According to Banking Control Law 1966 all banks are required to observe the statutory requirements to conduct banking business. No official special treatment is applied to Islamic banks under the Banking Control Law 1966. According to the Regulatory Consistency Assessment Programme (RCAP) and Assessment of Basel III Liquidity Coverage Ratio regulations for Saudi Arabia, SAMA regulates Shariah compliant banks in the same way as other conventional banks in the KSA. Therefore, in present the running system does not lead to any deviation from Basel standards (BCBS 2015). However, SAMA has implemented a *murabaha* facility for Sharia-compliant banks that is treated as a central bank reserve and can be included as High-quality Liquid Assets (HQLA) (BCBS 2015: 13). The facility can be classified as a *de facto* cash placement with the central bank, and it also replicates a treasury bill. Islamic banks are allowed to make withdrawals, if needed, from SAMA against the *Murabaha* facility. Furthermore, banks are allowed to use this product as collateral for central bank operations and can therefore generate liquidity when needed. The report considers the treatment of this product by SAMA in the LCR to be adequate.

4.8.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency and Disclosure

Banks are considered a company and should comply with the Company Law under the Ministry of Commerce as well as the accounting standards issued by the Saudi Organization of Certified Public Accounting (SOCPA). However, SAMA issued a manual to cover financial accounting standards for commercial banks (SAMA 2009). These standards consist of eight standards to be applied by banks in Saudi Arabia. SAMA points out that that Accounting Standards issued by the Ministry of Commerce can be used for any accounting issues not covered in the Accounting manual of SAMA. The accounting standards of Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) can be used as long as these do not contradict the existing standards or guidelines.

SAMA also issued Corporate Governance Regulation for banks that include a principle on Disclosure and Transparency. The principle stipulates that banks should publish all financial and non-financial information concerning different stakeholders to regulators and concerned parties (SAMA 2014). Similarly, SAMA issued Insurance Corporate Governance Regulations in 2015 that has a section on Disclosure and Transparency (SAMA 2015b: 12) and Articles 29 and 34 of Implementing Regulation of the Finance Companies Control Law includes transparency of information by these entities (SAMA 2015c). Further, Part 3 of the Corporate Governance Regulations issued by Capital Market Authority deals with Disclosure and Transparency (CMA

undated). CMA *Market Conduct Regulations 2004* also prohibits providing untrue statements. However, these transparency and disclosure do not specify anything specific for Islamic financial institutions.

Rating Agencies

The Credit Rating Agencies Regulations Issued by the Board of the Capital Market Authority Pursuant to its Resolution Number 3-58-2014 Dated 17/1/1436H (CMA 2014). These regulations outlines the conducts, activates and supervisions. A number of ratings agencies have applied for licenses and one of them is the Islamic International Rating Agency.

4.8.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

SAMA has issued different consumer regulation principles for different industries. These include *Finance Consumer Protection Principles, Regulations for Issuance and Operations of Credit and Charge Cards, Insurance Consumer Protection Principles and Banking Consumer Protection Principles*.³⁰ Similarly, CMA has issued *Market Conduct Regulations 2004* that prohibits manipulative and deceptive acts and practices and provides guidelines for dealing with clients.

Different programs on improving financial literacy have been established by financial supervisors. The SAMA established the Institute of Finance in 1964 that provides training to mainly banking professionals. The Capital Market Authority launched an interactive website called Smart Investor Program designed to raise awareness among young and potential future investors. However, there are no specific literacy programs on Islamic banking and financial products.

Deposit Insurance

Saudi Arabia does not have an explicit Deposit Insurance Scheme. However, a statement from the Supreme Economic Council in 2008 stipulates that authorities must ensure the safety of local banks and bank deposits which is implicitly considered to mean the full coverage of deposits (FSB 2015). SAMA has introduced an explicit Deposit insurance scheme starting January 2016 and further work is needed to enhance the financial safety net. Under the scheme, deposits of Islamic banks and conventional banks will be treated the same (FSB 2015: 56).

4.8.7. Human Capital & Knowledge Development Framework

It has been noticed that human capital and skills are needed to speed up development of the Saudi insurance industry. SAMA took the lead by establishing the Institute of Banking Training in 1964 which was renamed the Institute of Finance (IOF) in 2015. The mission of the Institute is to develop professionals in financial sector, offering programs to cater to financial needs, awarding certifications, and providing high quality solutions to develop professional

³⁰ <http://www.sama.gov.sa/en-US/Laws/Pages/ConsumerRulesAndRegulations.aspx>

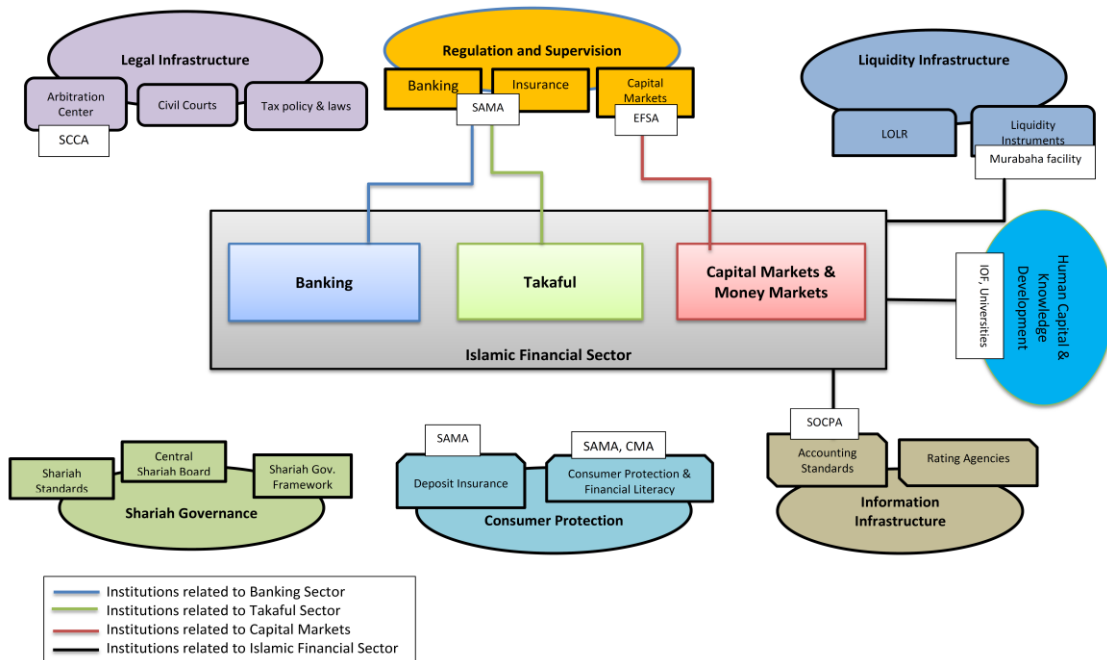
capabilities. Also, it offers specialized training courses and Qualifying Examinations such as the Retail Banking Professional Certificates and Saudi Stock Exchange (Tadawul) to certify brokerage firms’ employees to work on the Saudi brokerage system (Institute of Finance, 2016).

One of the first research centers in Islamic economics “Islamic Economics Research Center” was established at King Abdul Aziz University in Jeddah, Saudi Arabia in 1977. It was later converted to the Islamic Economics Institute in 2011. Several universities have also initiated academic programs in Islamic banking and finance. ICD and TR (2015: 119) report that there are 20 organizations offering courses in Islamic finance in Saudi Arabia.

4.8.8. Summary and Conclusions

While the constitution and laws of the country stipulate that Shariah is the basis of the legal system in Saudi Arabia, specific issues related to the financial infrastructure for Islamic finance appear to be lacking. Currently, the legislative and regulatory framework applied to Islamic banking and finance is similar to that of the conventional system. In order to reduce uncertainty and other associated risks in the application of Islamic finance, there is a need to make the application of Shariah to Islamic finance more transparent and accessible by codifying all associated laws. When this is successfully done, there is also the need to harmonize all the existing committees into a form that is much more easily accessible by surrendering all their functions to a specialized court. This means that the rules and principles of Shariah should be enforced as the primary source of law. Islamic financial products should be supervised and approved by a single Shariah board consisting of jurists, lawyers, economists and others. This should have a positive effect in helping to develop the rules, reducing the risk of disputes, realizing the objectives of Shariah and instilling confidence in the market.

Chart 4.8: Islamic Financial Architecture Institutions—Saudi Arabia



4.9. Senegal

Senegal, a nation on the northern fringes of the Sahel has a population of 13.97 million in 2015 with 95% of them being Muslims (CIA 2016). While West African countries are part of the Economic Community of West African States (ECOWAS). The region is also grouped into two consortiums along linguistic lines. Senegal is a member of eight West African French speaking countries forming West African Economic and Monetary Union (WAEMU).³¹ The member states of WEAMU share the same currency, CFA Franc, that is issued by Central Bank of West African States (BCEAO) and pegged to the Euro (Allen et. al . 2011). The Banking Commission under the BCEAO oversees and supervises banks and financial institutions in member countries.

There are 26 financial institutions in the country (23 banks and 3 credit institutions) of which the Islamic Bank of Senegal (BIS) was established in 1982 by the group Dar-al-mal al Islami. Later, the government of Senegal took the majority shares of the bank and turned it into a conventional bank. Later in 2010, with the Islamic Finance Forum and the new trend of Islamic Finance, ICD (the private arm of the Islamic Development Bank) and Bank Asya took a 70% stake of BIS's shares with the intention of turning it into a fully fledged Islamic Bank.³² BIS is expected to command 10% of the market share by 2016 (IFN 2016). Other Islamic financial institutions in the country include Islamic Investment Company of Senegal and Salama Assurance Sengal (formerly SOSAR), a subsidiary of Dubai based Islamic Arab Insurance Company (IFN 2016; Abdullahi 2013).

The regional stock exchange for WAEMU *Bourse Regionale des Valeurs Mobileres* (BRVM) started in 1998 (Allen 2011: 96). Located in Abidjan, it has branches in capital cities of all member countries. Senegal was the first West African state to issue a four year ijarah sukuk in 2014 that raised XOF 100 billion (USD 163.13 million) (IFN 2016). Being the first Islamic security of its kind in the region, Senegal has successfully entered the race of being the West African hub for Islamic finance and has set the tone for other countries like South Africa and Ivory Coast.

4.9.1. Legal infrastructure

Supporting Islamic Finance laws

The banking sector in Senegal is governed by the common WAEMU Banking Law which allows Shariah compliant banking activities and further clarifications to the law are being made for Islamic banking (Gelbard et. al. 2014: 10). The Central Bank of West African States allowed Islamic banking in its conventional legal and regulatory framework allowing Islamic banks to operate under the label “financial institutions not using interest rates”. In July 2008, the former President Abdoulaye Wade promulgated the law that regulates the banking system. The set of laws do not include any references to Islamic finance. There are no specific Islamic capital market laws. Senegal issued its sukuk under existing financial laws (EIU 2015: 17). Similarly, there are no specific laws covering the takaful.

³¹ Other members of WAEMU are Benin, Burkina, Ivory Coast, Guinea Bissau, Mali, Niger and Togo

³² Note that operations of Turkey's Bank Asya were suspended on 23 July 2016 and the impact of this on the status of its ownership in BIS is not clear.

Tax regimes and impact on Islamic Finance

The DGID (The Direction of Taxes and Properties), a branch of the Ministry of Finance, included the waiver of double taxation for Murabaha products used by financial institutions in case of the sale of an asset in its Tax Law of 2013. This was an indication from the authorities of the government's will to encourage the development of Islamic finance in the country. However, the taxation system has no specific dispositions for sukuk despite the issuance of a sukuk by the government of Senegal in 2014. When Senegal issued the sukuk, the CREMPF (the Central Bank body regulating Financial Markets) had to work with ICD of Islamic Development Bank Group to adjust the rules and adapt these to fulfill the requirements of the transaction to issue the sukuk.

Dispute settlement/conflict resolution framework and institutions

The actions taken by the government to create a sustainable and easy way to do business are at the core of the national strategy. Therefore, disputes including commercial ones are settled in civil courts. Nevertheless, the Decree-Law 2014-1653 of 2014 tackles the issue by establishing an ombudsman that settles conflicts involving banks, microfinance institutions and post offices. This law treats Islamic and conventional finance equally. As the current law is inspired by the French constitution and laws, it does not mention Shariah. As such, Islamic finance is not treated differently and falls under the current laws. Furthermore, the professionals in the legal system lack training to deal with Islamic finance issues.

Bankruptcy and resolution of banks

Under Senegalese law, financial institutions that wish to withdraw their license must notify the Minister of Economy and Finance and the request is processed by the Central Bank. There are no specific resolution mechanisms for Islamic financial institutions. The judiciary is not equipped with the proper instruments or training to deal with defaults sukuk for resolving either domestic or cross border issues.

4.9.2. Financial System Regulation and Supervision Framework

The Central Bank of West African States BCEAO allows Islamic banking in its regulatory framework under the label "financial institutions not using interest rates". However, the regulations do not differentiate between conventional and Islamic finance. Licensing agreements are the same for Islamic and conventional finance. Even though BCEAO has been a member of IFSB since 2012, IFSB standards are not yet applied to Islamic banks. There are no sharia compliant instruments that can meet Basel III tier 1 or 2 capital requirements. Even though a few conventional banks applied for Islamic windows, the Central Bank has not given any authorizations. There are no financial soundness indicators for Islamic banks.

Inter-African Conference of Insurance Markets (CIMA) established in 1992 regulates and supervises the insurance industry under its regulatory body Regional Commission of Insurance Control (CRCA) covering 14 West African and Central countries including Senegal (Allen et. al. 2011). CIMA uses conventional insurance codes as basis of its regulation. Without the authorization of CIMA, no Takaful activities can be taken. This may require adding takaful features in the existing codes.

Conseil Regional de L'Epargne Publique et Des Marches Financiers (CREMPF) controls all the activities related to capital markets in general and the regional stock exchange for WAEMU *Bourse Regionale des Valeurs Mobileres* (BRVM) in particular. Located in Abidjan, the conventional financial infrastructure of BRVM is quite strong. The volume of operations in the capital market, however, is not that significant compared to the Johannesburg Stock Exchange. There are no specific regulatory frameworks for Islamic capital markets.

4.9.3. Shariah Governance Framework

Despite the fact that Islamic finance institution can be licensed under the current law, there are no regulatory requirements for Shariah supervision at the financial institution level in banking, takaful or capital markets sectors. There are no central Shariah supervisory boards or guidelines regulating SSB for Islamic financial institutions. However, the Central Bank has recently selected an advisor to elaborate a complete set of rules regarding the matter. AAOIFI/IFSB Shariah governance standards are neither required nor taken into consideration by the Central Bank.

4.9.4. Liquidity Infrastructure

A set of prudential rules enunciates the means by which banks and microfinance institutions should operate. These rules include abiding by a liquidity ratio that applies to both conventional and Islamic banks. The national branches of central bank located in all eight countries receive monthly notes regarding the sector. Hence, banking authorities managed to put in place infrastructures that guarantee transparency and follow up. There are no interbank money markets for Islamic financial institutions. The only existing money market uses interest rates in the conventional banks. Liquidity management instruments and LLOR for Islamic financial institutions are also nonexistent.

4.9.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency and Disclosure

The current accounting system used in the country is OHADA which are accounting and auditing standards in line with international IFRS but covering the specifics of the WAEMU countries. Even though OHADA lacks the specificities of Islamic banking, takaful or capital markets, it is applicable to both conventional and Islamic banks. The Central Bank, in its effort to strengthen the financial sector, requires financial institutions to produce quarterly and annual reports. Other than reviewing financial figures provided, it monitors the financial institutions and gives the appropriate orientations.

An accounting system in line with AAOIFI standards and covering the specifics of the OHADA norms has not been considered yet. Even though there are no specific dispositions for IFIs or sukuk issuance regarding AAOIFI and IFSB standards, the conventional set of laws has strong requirements for transparency and information disclosure regarding financial institutions in general and conventional capital markets instruments in particular. Islamic finance instruments fall under the same set of laws.

Rating Agencies

Located in the Ivory Coast, the host of Bourse Regionale des Valeurs Mobileres, the West African capital market, Bloomfield Investment Co is the only ratings agency in West Africa. Their expertise does not cover Islamic Finance. The Islamic bank of Senegal owned by ICD works closely with IDB's rating agency named IIRA (<http://www.iirating.com>)

4.9.6. Consumer Protection Architecture

Consumer protection and financial literacy

WAEMU banking commission ensures the safety of the sector. Circular No. 5-CB/C/CB deals with the governance applied to the financial institutions in WAEMU.

There is a set of legal organizations that protect consumers for the financial sector in parallel with the laws protecting consumers. The Senegalese consumer association counts 28,000 members. It investigates and sues any organization that threatens the interests of the customer. However, there are no specific organizations or orientations targeting the IFIs. Similarly, there is a literacy scheme for conventional finance with no specifics for Islamic finance.

Deposit Insurance

There are no deposit insurance schemes for Islamic finance institutions.

4.9.7. Human capital and knowledge development frameworks

The African Institute of Islamic Finance (AIIF-Advisory and Training), a private institution founded in 2009, is the main institution providing Islamic finance training for professionals, and it also provides certificates and an Executive MBA in Islamic Finance. The African Institute of Islamic Finance has trained staff of the Islamic Bank of Senegal and close to 2,000 professionals in the financial sector including bankers, insurance company staff and governments agents. The African Institute of Islamic Finance organized three Islamic Finance Forums in the past in partnership with the Ministry of Finance, and it is backed by the government and the industry to extend its training capacity with Middle Eastern institutions such the Bahrain Islamic Banking and financial institutions (BIBF) in the nearby countries. However, a clearly defined policy to promote the African Institute of Islamic Finance training initiatives is yet to be undertaken by the government to fill the IF expertise gap.

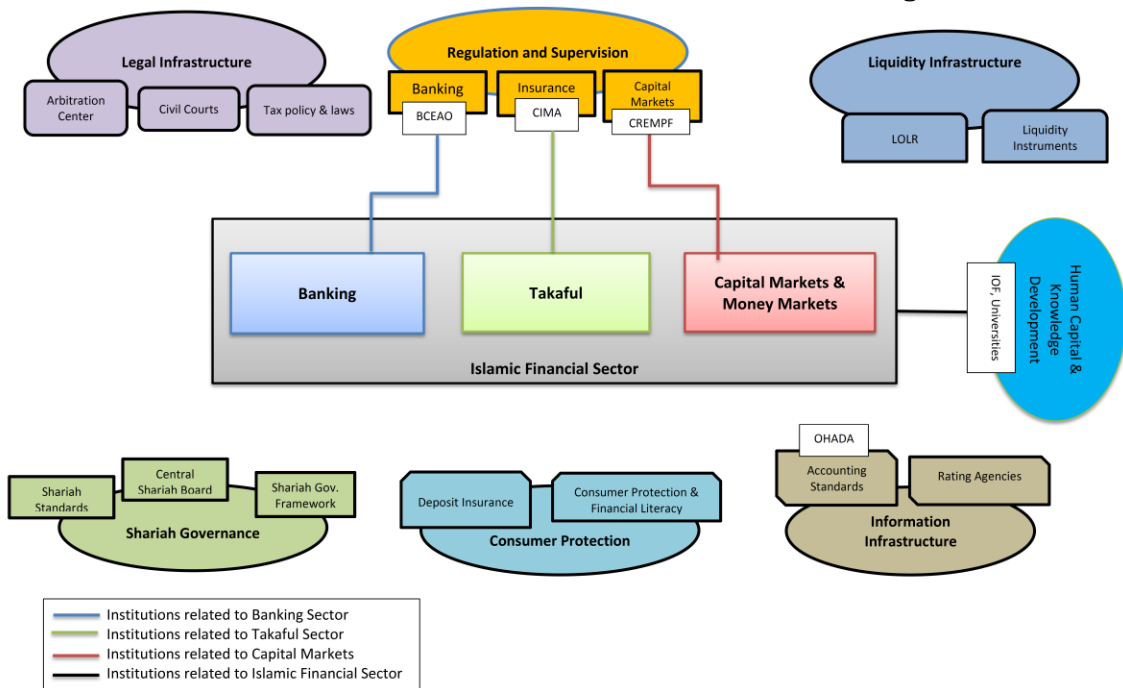
Recently, a few initiatives from Senegalese universities and business schools have emerged to offer Master programs in Islamic Finance, but the lack of expertise and skillful trainers is a major roadblock. The University of Paris Dauphine has partnered with a major regional Business School in Dakar to develop an academy for Islamic finance in the near future.

4.9.8. Summary and Conclusions

The specific institutions related to the Islamic financial architecture in Senegal are still lacking. Even though Senegalese authorities have shown the political will to drive the changes required for that purpose, only meager changes in the legal environment have taken place to adapt to

Islamic finance. While Senegal was first to issue a sukuk and is poised to become a hub for Islamic finance in the West African region, the country has to overcome the regulatory environment challenge of allowing Islamic finance institutions to prosper through a specific legal infrastructure taking into account all of its specifics. One of the problems of developing a sound financial architecture for Islamic finance is that Senegal has to follow the laws and regulations at the regional level. For example, while the Central bank of West African States (BCEAO) was a pioneer in 1982 to allow Islamic banking under the existing laws, not much has been done to meet the specific needs of the Islamic financial industry. The promotion of Islamic finance in the country would require more specific financial infrastructure that can support the industry and cater to the huge demand in Islamic finance products in the country.

Chart 4.9: Islamic Financial Architecture Institutions—Senegal



4.10. Sudan

The Islamic banking and finance industry emerged in Sudan during the Economic Openness Period (EOP) during the years 1976-1983 that witnessed major economic reforms (Abushora et. al 2006). The Central Bank of Sudan (CBOS) differentiates between two periods of Islamization of banking and the financial system. The first was the "Stage of Declaration and Starting Islamic Banking" which started after the announcement of the Shari'ah law in 1983 (that prohibited *riba*) and the enactment of the Civil Transactions Act of 1984. This ended in 1988. CBOS also issued a circular (Number 11 / ر ع م / ب) in 1984 stipulating the prohibition of dealing in interest rates and instructing all banks to convert from conventional to Islamic banking. Thereafter, the whole banking system was completely transformed to Islamic and many private Islamic financial institutions continued entering the market.

The second stage, the "Stage of Deepening Islamic Financial System", occurred during the years 1989-2003. This period witnessed the Islamization of insurance companies, merging of some government banks, liquidation of some private banks, changing the names of some banks, and emergence of investment banks (Abushora et. al 2006). In 1992, the Minister of Finance issued Decree Number 219 which enforced the conversion of all conventional insurance companies to Islamic insurance companies (Sulieman, 2013). The period also witnessed the emergence of the Khartoum Stock Exchange (KSE) in 1994. KSE Act of 1994 was issued and the primary stock market started operations in the same year and the secondary stock market in 1995 with 34 listed companies, (Al-Sayed, 2011).

Several Islamic banks existed in Sudan before the Islamization of the financial sector. Faisal Islamic Bank (FIB) was established in the country in 1977 followed by Al-Tadamon Islamic Bank in 1980, Sudanese Islamic Bank and the Islamic Cooperative Development Bank in 1982, and Al-Baraka Bank Islamic Bank of Western Sudan in 1983. Similarly, the Islamic Insurance Company (IIC) commenced operations in January 1979 as the first Islamic insurance company in the world (Bekkin, 2009). It was followed by Al Baraka Insurance Company in 1985, National Cooperative Islamic Insurance Company (renamed Taawuniya) in 1989 and El Salama Insurance Company in 1992. The Shiekan Insurance and Reinsurance Company was established in 1983 as a conventional insurance company which converted to an Islamic insurance company in 1990.

The Islamic financial industry has grown rapidly in Sudan. Other than Islamic banks, *takaful* companies, Khartoum Stock Exchange, many nonbanking financial institutions such as exchange bureaus, *ijarah* companies and microfinance institutions operate under the direct supervision of CBOS. The financial sector in Sudan is dominated by banks which represent 97% of the financial sector. Insurance companies stand for approximately 3%. The total Islamic banking assets of 28 banks in Sudan account to USD 10.651 billion in 2014, making the country the 13th largest in the world. Thirteen *takaful* companies and two *takaful* reinsurance companies operate in the country (CBOS, 2014). The total size of the direct premium has increased significantly from USD129 million in 2010 to USD 250 million in 2013 while the indirect premium (reinsurance premium) increased from USD 49 million to USD 100 million in the same period (ISA 2011; ISA 2013). The Khartoum Stock Exchange (KSE) has also witnessed successive growth during the last years with 60 companies, 27 investment *sukuk*, and 45 investment Certificates listed as of 2013 (KSE, 2013). KSE changed from manual to computer-based trading in January 2012. However, trading in KSE is dominated by Government

Musharakah Certificates (GMCs) which represent approximately 80% of the traded value (KSE, 2013).

4.10.1. Legal Infrastructure

Supporting Islamic Finance Laws

The Sudanese legal system is based on a combination of English common law and Islamic Shari'ah law. Before the introduction of Islam as the basis of the country's legal system in 1983, Sudan used English common law. After the introduction of Shari'ah in 1983, some of the laws were changed and this included the the Civil Transaction Act of 1984 (CTA 1984) dealing with sale of goods and services, companies, land and torts. The laws draw upon civil law concepts from the Egyptian, Jordanian and French legal systems and are similar to comparable laws adopted in other parts of the Arab world. The CTA 1984 was complemented by the Sources of Judgments Act of 1984 (SOJA 1984) which requires judges to interpret laws in accordance with Shari'ah principles. While most of the English law based statutes were cancelled, a few were such as the Companies Act of 1925 and the Bankruptcy Act of 1929 were amended (IMF and WB 2005).

The Bank of Sudan Act, 2002 including 2006 and 2012 amendments (BOS 2002) defines various roles and objectives of the CBOS and stipulates that institutions must fully adhere to Shari'ah principles (BOS Act, 2012). The Banking Business (Organization) Act, 2003 (BBA 2003) provides the rules of granting and withdrawing bank licenses and also authorizes CBOS to supervise and control banking and financial institutions. It authorizes CBOS to inspect banks and financial institutions under its supervision to ensure that the whole banking sector complies with CBOS laws and regulations. It establishes the Shari'ah High Supervisory Board (SHSB) and authorizes it to supervise and monitor the implementation of Shari'ah rules and principles in the banking sector (BBA 2003).

The Takaful sector in Sudan is governed by the Controller of Insurance Act, 1960 (CI Act, 1960) which remained in effect and was applicable to all conventional and Islamic insurance companies until it was repealed in 1992 following the adoption of the Insurance Supervision and Control Act, 1992 (ISC 1992) and the Insurance Control Act, 2001 (IC 2001). Modifications were made to adapt the Islamization of insurance system which started in 1992 (Suliman, 2013). The Insurance and Takaful Act 2003 (IT 2003) was initiated to fill the gap and identify the range, subject matter, and parties of insurance and takaful contracts that should be used as a reference before courts. IT 2003 also distinguished life insurance to be distinct from general insurance (IMF and WB 2005).

Capital markets in Sudan consist of KSE where equities, GICs, Sukuk, and securities certificates are traded. It is governed by the Khartoum Stock Exchange Act of 1994 (KSE ACT 1994), and Financial Markets Regulation Authority Act of 2015 (FMRA Act 2015). The legal framework of KSE is also supported by other related laws such as Sukuk Act of 1995 (SA 1995) and the Civil Transactions Act of 1984 (CT 1984).

Tax regimes and impact on Islamic finance

As the whole financial system in Sudan is Islamic, issues related to disparities between the conventional and Islamic financial sectors do not arise. Overall, the Sudanese taxation system comprises VAT, Custom Duty Tax (CDT), and Business Profit Tax (BPT). While BPT on banking sector is 30%, it is exempted from VAT and CDT on banking equipment. Specifically Articles 37(1) and (2) of the VAT law exempts certain items including banks, insurance companies, sales of sukuk and stocks (Siddig, 2014). The taxation system in Sudan accommodates the unique features of sukuk. The profits of all kinds of investment certificate sukuk, and any other financial investment instruments, are completely exempted from BPT as per clause number (20/a) of the Sukuk Act of 1995.

Dispute Settlement/Conflict Resolution Framework and Institutions

Since the financial sector of Sudan completely follows Islamic Shari'ah Principles, the legal framework, including disputes settlement and resolution framework has also been transformed and adjusted to comply with the Islamic Shari'ah principles. The judicial structure of the country has specialized courts that include Commercial Court, Intellectual Property Protection court, Public Property Court, and Environment Court, (Judiciary 2016). The Commercial Court was established in January 2002 following the Judiciary Law 1986 with the formal name "Khartoum Commercial and Intellectual Property Court" (KCIPC) and deals with all business-related disputes. It is concerned with commercial disputes, and, when contracts are claimed to be non-Shari'ah compliant, the SHSB of the CBOS solves such issues. There has never been a case of an appeal brought from the SHSB to any court (IMF and WB, 2005).

Arbitration constitutes an alternative dispute resolution framework in Sudan and all commercial and civil matters are considered arbitrable by law. Arbitration is managed by the Khartoum Center for Commercial Arbitration (KCCA) and is governed by The Arbitration Act of 2005 amended 2016. This act is not based on the Model of the United Nations Commission on International Trade Law (UNCITRAL). Sudan has not yet signed the 1958 New York Convention³³ but has approved the International Center for Settlement of International Disputes (ICSID) Convention (TWB, 2010). Sudan faces the challenge of complying with some of the international standards that disregard Islamic Shari'ah principles. Although Arbitration Act 2016 has made different amendments in different clauses of the Arbitration Act, 2005, the clauses related to International Arbitration remain without changes (Arbitration, 2016). It is quite difficult to spot the number of commercial arbitration disputes in Sudan. It was reported that most commercial arbitration disputes in Sudan are unplanned or under international arbitration institutions without providing additional details. ICSID has reported two continuing disputes (UNCTAD 2015).

³³New York Convention 1958 on the Recognition and Enforcement of Foreign Arbitral Awards entered into force in June 1959. The Convention requires national courts to recognize and enforce foreign arbitral awards, subject to specified exceptions; requires national courts to recognize the validity of arbitration agreements, subject to specific exceptions; and requires national courts to refer parties to arbitration when they have entered into a valid agreement to arbitrate that is subject to the Convention (World Bank, 2010).

Bankruptcy and Resolution of Banks

While bankruptcy of individuals is governed by the Bankruptcy Act of 1929, bankruptcy of companies including banks is governed by the Companies Act of 1925 amended in 2015. The amendments made to the Companies Act 2015 include clauses that comply with contemporary bankruptcy rules and practices. For instance, Chapter Five of the law provides the rules of merger (Companies Act, 2015). The Property Mortgaged to Banks (Sale) Act, 1990 (PMTBSs) Act of 1990 along with the Companies Act of 1925 amended 2015, and Bankruptcy Act of 1929 work together to protect banks and enforce the repayment of unsettled bank credit facilities. PMTBSs 2003 states that a bank may enforce the repayment of debt without recourse to a court of law. The Act stipulates an easy and simple process whereby a bank gives short notice to the defaulter to pay the outstanding credit amount, and, in case it is not settled, can proceed immediately with the sale of the mortgaged collateral, usually real estate, in a public auction. It also spreads on the recovery of pledged movable property. While sukuk issuance, regulations, and requirements are stipulated in the Financing Sukuk Act of 1995, there are no special bankruptcy laws to deal with sukuk. Chapter Three of the Act states the rules of establishing the Sukuk Issuance Committee and defines its main activities. Clause number (22), chapter four of the Act determines the sanctions against breaching the law by minimum one year prison or fine or both, (Sukuk Act, 1995). No special rules deal with cross-border sukuk or investment instrument.

4.10.2. Financial System Regulation and Supervision Framework

The Financial sector in Sudan comprising banks, nonbank financial institutions, takaful companies and capital market is regulated and supervised by three main regulators. The CBOS Act 2002 amended 2006 and 2012 and Banking Business (Organization) 2003 gives authority to CBOS to regulate and supervise banks and nonbank financial institutions such as exchange bureaus, ijarah companies, microfinance institutions, guarantee mutual funds and sukuk (CBOS, 2012). CBOS was one of the main founding members of the IFSB, (Elzubair, 2013). It has instructed banks and financial institutions to adhere to the IFSB Standard Guidelines for Islamic financial institutions, (CBOS, 2009; CBOS, 2015). The Basel Committee on Banking Supervision (BCBS) framework in Sudan is adopted by the amendments and adaptation of the IFSB standards in order to comply with Shari'ah principles. As such, banks in Sudan utilize the formula provided by IFSB in calculating the capital adequacy ratio (CAR) (Mejia et. al. 2014). Shari'ah compliant instruments that can meet the Basel 3 Tier 1 and Tier 2 capital requirements are not adequate. However CBOS and Sudan Banks Union (SBU) are trying to find Shari'ah tolerable instruments. Sudan applies the same standards of the most important bank financial soundness indicators (FSIs) that have been issued by the IFSB in light of the Basel framework such as CAR, assets quality ratios, profitability, liquidity ratios, etc. (CBOS, 2014).

Insurance and Reinsurance Companies in Sudan are regulated by the Insurance Regulatory Authority (ISA) under the Minister of Finance and National Economy. Until the year 1992, the insurance industry in Sudan was regulated by the Controller of the Insurance Act of 1960 which remained effective and applied to both conventional and Islamic Insurance and Reinsurance Companies. Significant changes were made to the insurance legal system in 1992 when the insurance industry was transformed from the dual insurance system to complete the Islamic Shari'ah system (Sulieman, 2013).

The Financial Markets Regulations Act 2015 (FMRA 2015) made the Financial Markets Regulation Authority (FMRA) the regulators of capital markets in Sudan. The regulations framework also included the Trading Regulations of 2010 and the Settlement and Clearing Regulations of 2010. Both regulations were based on the KSE Act of 1994 (KSE 1994). According to Clause 16 of Chapter Three of the KSE 1994, the KSE is governed by the KSE Board of Directors (BOD) that includes the Minister of Finance (chairman) and CBOS Governor (deputy chairman). The registration of brokerage companies is regulated by the Registration Brokerage Companies Requirements that have been issued by the KSE Board of Directors in meeting number (6/2005) dated 12/10/2005, (KSE, 2005).

The Sudan Financial Services Company (SFSC) owned by CBOS and the Ministry of Finance and National Economy was established specifically to control the issuance and trading of Investment sukuk and government investment sukuk directly to the public or through public brokerage Companies in KSE and all CBOS branches in different regions of the country. The company organizes auctions in the Security Primary Market for trading Government Musharakah certificates (Shahama), Government Investment Certificates (SARH), CBOS Ijarah Certificates (Shihab), Khartoum Oil Refinery Ijarah Certificates (Shama), in addition to the Sudanese Electricity Distribution Company Ijarah Certificates (Shasha) in local currency, and the Sudanese Electricity Transmission Company Ijarah Certificates (Noor) in US dollars, (SFSC, 2016; CBOS, 2014). In addition, CBOS also established the Tarweeg Investment Company with the aim of achieving immediate settlement of all purchased and sold securities on behalf of customers, and it also operates as an arm of CBOS in secondary markets to contribute to the achievement of the monetary policy purposes through open market operations along with the promotion of all securities and products of the SFSC in both the primary and secondary markets (CBOS 2014).

4.10.3. Shariah Governance Framework

Shari'ah governance for banks is regulated by a central Shari'ah Supervisory Board while clause (2) of the Banking Act of 1991 has created the Shari'ah High Supervisory Board (SHSB). It delegates to the SHSB the role of supervision and the accomplishment of Shari'ah rules within CBOS and all banks. The SHSB encompasses experts in Sharia rules and principles, economics, and banking. It also supervises the CBOS policies as well as the activity of banks and financial institutions to ensure full compliance with the Shari'ah rules and principles. All banks are also instructed to establish a Shari'ah Supervisory Board (SSB). Appeals from SSB are heard by the SHSB. Fatwas issued by SHSB in any disputes related to banks activity are obligatory on CBOS, bank, and other financial institutions unless they appeal to the judiciary (IMF and WB 2005).

Insurance Companies for Shari'ah governance are regulated by the High Shari'ah Supervisory Board (HSSB) for the insurance sector. HSSB has been established in accordance with Article 7 of the Supervision and Control Act of 1992 and with the resolution of the Minister of Finance and National Economy No. 219 for the year 1992 to form the HSSB of the ISA. Each insurance Company also has to establish its own Shari'ah Supervisory Board. The main objectives of the HSSB are to issue Fatawa on matters raised by the ISA, cleanse insurance operations from any kind of non-Shari'ah compliant transactions, and standardize the vision of the Shari'ah Supervisory Boards of the insurance companies (Sulieman, 2013).

KSE is also regulated by a separate Shari'ah Supervisory Board (SSB) which was established based on the KSE Act of 1994. SSB comprises three members to be selected by the General Assembly from Islamic Shari'ah scholars who have knowledge of financial transactions. SSB's main role is to supervise and monitor KSE operations and ensure compliance with the provisions of Islamic Shari'ah (KSE, 1994). Although the KSE Act of 1994 has been amended in 2015, no changes have occurred in all clauses related to the formation and the role of the SSB (KSE Act 2015).

All regulations related to Shari'ah supervisions for banks, takaful companies and KSE provide the rules for SSBs at the organizational levels. These issues identified include ascertaining the position of SSB in the governance structure, defining the role of SSB members, approving the appointment of SSB members and the qualifications and minimum number of members in the SSB.

4.10.4. Liquidity Infrastructure

CBOS regulates and controls the liquidity management framework through different tools and arrangements. Banks are allowed to keep liquid assets of a maximum of 20% of the financing portfolio in a form of any of CBOS's Ijarah Certificates (Shihab), Government Musharaka Certificates (Shahama), Khartoum Oil Refinery Ijarah Certificates (Shama), and other Government Institutions Sukuk (CBOS, 2015). With regards to the inter-bank market, CBOS encourages banks to bring into being syndicates for financing productive sectors, keep deposits and credit financing in both local and foreign currencies, the sale and purchase of Sukuk and Investment Certificates, and dealing in foreign exchanges between banks. CBOS also encourages banks to cooperate and coordinate together to unify their financing and exchange rate policies, establish monetary funds for liquidity management, and to securitize their capital assets, (CBOS, 2015).

Another important tool is the Liquidity Management Fund (LMF), which was established in September 2014 as a special purpose vehicle (SPV) jointly owned by Sudanese lenders and managed by the Financial Investment Bank. By establishing the fund, CBOS is no longer involved in the daily liquidity requirements of the banks except as a lender of last resort. Member banks are requested to put in capital a combination of a minimum 40% cash contribution and 60% in a form of investment securities or Sukuk (Reuters, 2015). The latter includes CBOS Ijarah Certificates (Shihab), Government Musharaka Certificates (Shahama) and other investment Shariah compliant securities. These instruments are also used to manage liquidity at the macro economy level through open market operations. The certificates are also considered by CBOS as low risk, high profitability, can be presented as a first class guarantee for obtaining credit financing from the banking system, and it can be quickly liquidated through KSE directly or through agency companies operating in the KSE (IIFM, 2010). Basel 3 liquidity requirements have not yet been implemented in Sudan. However, the liquidity management tools, namely the Liquidity Management Fund and CBOS and GICs, can be used to fulfill the requirements of Liquidity Coverage Ratio (LCR) and the High Quality Liquid Assets ratio (HQLA).

CBOS acts as the lender of last resort using two windows. First, the Liquidity Deficit Window (LDW) is used to finance through mudarabah or investment deposit. In case the borrower's bank has repaid the finance within seven days, it will be exempted from paying any profit to CBOS. But if it exceeds the seven days, profit will be distributed between rabbulmal and

mudarib based on 90% to rabbulmal and 10% to mudarib. Second, the Investment Financing Window (IFW) uses mudarabah or musharakah whereby CBOS raises tender for banks in certain periods and the tender awarded to banks based on the percentage of musharakah or profit percentage of mudarabah (Hassan, 2004).

4.10.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency and Disclosure

Accounting and auditing principles and regulatory framework for government and corporations are generally guided by accounting procedures, standards and fiscal accountability provisions described in the 1977 Financial and Accounting Procedures Law (and its amendments) and 1995 Financial and Accounting Procedures Regulations 1995. Since 1988, banks and financial institutions have been following the Islamic accounting standards approved by the Accounting and Auditing Organization for Islamic Institutions (AAOIFI) (IMF and WB, 2005; WB 2010). Also CBOS in its annual policy program for banks and financial institutions instructs all banks and financial institutions to comply with IFSB, (CBOS, 2015). However CBOS allows banks in certain cases to use the International Accounting Standards (IAS).

CBOS requires banks and financial institutions to be transparent and disclose adequate information. CBOS circular number (11/98) and also CBOS circular of transparency and financial disclosure number (1/2002) dated 9/2/2002 (IFF, 2016) have defined the Standard of the Presentation and Disclosure for IFIs. Sukuk standards are stipulated within the Sukuk Act of 1995 and are also disclosed in the Sudan Financial Services Company website and Sukuk and investment certificates pamphlets.

Rating Agencies

The Credit Information & Scoring Agency Act, 2011 (CISA Act, 2011) regulates and governs the function of exchanging credit information and tracks a record of customers who have been granted credit facilities from any bank or financial institution during a period of time. It puts the rules of the establishment of the Credit Information and Scoring Agency (CISA) and defines its function and role as the highest administrative authority and credit bureau that control exchanging customer credit information with banks and financial institutions (CISA Act, 2011). The Credit Information and Scoring Agency (CISA) set up by CBOS is responsible for controlling the credit information and rating system that help banks to make good credit decisions, assess the creditworthiness of customers based on their credit history and track record, and analyze the credit behavior of customers. It also provides the credit risk scoring and classification of customers (CBOS 2014). There are no rating agencies providing credit ratings for securities and sukuk issuance in Sudan. Also, no ratings agencies provides Shariah ratings of Islamic banks and sukuk structures.

4.10.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

Although the local government of Khartoum Regional State has adopted the Commerce Regulation and Consumer Protection Act (CRCPA) number (8) of the year 2012, it does not include any clauses that protect the consumers of the financial sector (CRCPA, 2012). However the Civil Transaction Act of 1984 (CT Act, 1984) and Companies Act of 1925 amended 2015 and Criminal law of 1991 (clause 177 (1), criminal breach of trust) all together accommodate consumer protection in Sudan. There is no Ombudsman or specific institutional mechanism found in Sudan where consumers can report or claim unfair treatment.

There is no special financial literacy scheme for consumers in Sudan. This can be seen by the low private domestic savings rate in Sudan and the fact that financial intermediation is drastically less deep and less developed. The ratio of domestic savings to GDP is only 10% in 2012 which is below the Sub-Saharan average of 20% and most neighboring countries. Poor financial literacy, low income levels, a large informal sector, the small size of banks and their limited geographical spread are the major reasons behind this low performance. Only 7% of adults, have bank accounts which is lower than the average of 24% in Sub-Saharan Africa, 18% in the Middle East and North Africa, and the world average of 50%, (Siddig, 2014). One of the main objectives of the Sudan Banks Union (SBU) is to disseminate Islamic banking awareness in the community and to foster and improve confidence in the banking and financial system. Most of the activities of the SBU are limited to banking training courses and workshops. It also provides masters and PhDs scholarships to applicants from bank staff who meets their terms and conditions. It has sponsored 18 PhDs and 15 masters during the period 2002-2014, (SBU 2016).

Deposit Insurance

The Bank Deposits Security Fund Act, 1996 (BDSF Act, 1996) provides the legislation related to the deposit insurance system, including the establishment of the Bank Deposit Security Fund (BDSF) that represents the administrative authority of the deposit insurance system, (BDSF Act, 1996). Following the issuance of the act, the Islamic Deposit Insurance System (IDIS) in Sudan was initiated in 1996. It is managed by the Bank Deposit Security Fund (BDSF), a CBOS entity (CBOS 2104). The system is completely Shariah-compliant where the BDSF adopts *Takaful* contract for its deposit insurance. *Takaful* contract works based on collaboration between the Ministry of Finance, CBOS, banks, and depositors. The adoption of *Takaful* contract was approved by the High Shari'ah Supervisory Board. IDIS operations are funded by the payments received from the banks. Annual premiums are calculated based on the average total insured deposits as at 31 December of the previous year on a flat rate basis. Each of Ministry of Finance and CBOS pay 10% of the total amount of the annual banks' calculation. The *Takaful* fund for the guarantee of current and savings deposits is paid by banks, Ministry of Finance, and CBOS. The *Takaful* fund for the guarantee of PSIA's is paid by PSIA's holders, and the *Takaful* fund for financial insolvency incidents is paid by banks, Ministry of Finance, and CBOS. BDSF's capital was provided for by an initial payment from the CBOS, Ministry of Finance, and banks. Membership is obligatory for all banks including branches of foreign banks. The maximum coverage limit for savings deposits is USD 1,500 per depositor per bank and the maximum coverage for PSIA's is USD 2,000 per depositor per bank, (IADI, 2010).

4.10.7. Human Capital & Knowledge Development Framework

Many government and private universities in Sudan offer Bachelor degrees in Finance and Banking specialization and some of them offer Master and PhD programs. The Sudan Academy for Banking and Financial Sciences (SABFS) offer programs for bachelor degree on both banking and insurance studies. It also offers short training courses that help enhancing human capital in the banking, Finance, and Insurance studies (SABFS, 2016).

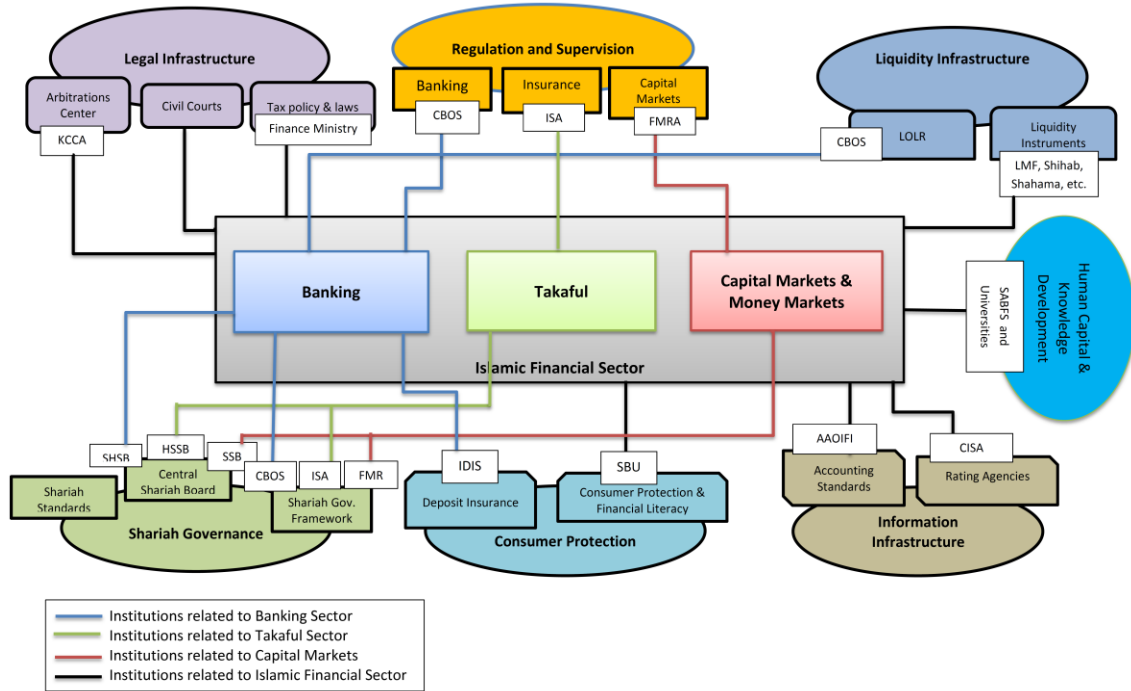
Sudan is also involved in the Capacity Building for Improved Quality of the Educational System and Skills Development Project (CBIQESSDO) with the African Development Bank Group (ADB). The purpose of this project is to support the strategic and operational capacity of the education and training system to maintain the major functions of planning, management and evaluation that are necessary to develop human capital in Sudan. Although the project is concerned with all fields of education, it also includes the development of skills and technology of Banks Human Capital as part of Sudan's development strategy (2014-2018) and the Bank Ten-year Strategy (ADB, 2015).

4.10.8. Summary and Conclusions

Despite the significant expansion of banks and other financial institutions in the last few years, and the plethora of laws and regulations, Sudan's financial sector is still underdeveloped compared to the Sub-Saharan region and most neighboring countries. In spite of these apparent weaknesses, Sudan became the first country to adopt a completely Islamic financial sector. The development approach included the conversion of the banking, insurance, and capital markets, as well as the innovation of the GICs as a tool of liquidity management, interbank, and general budget finance through open market operations. The system needs serious action to enhance financial literacy and enlarge access to banking and insurance services including shortening the procedures for opening bank accounts and improving banking and insurance services. Banks and insurance companies need to be encouraged to open new branches, particularly in such a large country with many isolated rural areas that witness very low financial awareness and are hardly served by well-developed transport infrastructures.

It is worth noting that issues arising in financial architectural institutions are mitigated to a large extent in countries that have adopted Islamic legal and financial systems. As the legal and financial systems in Sudan are Islamic, the disparities in different infrastructure institutions that exist for Islamic finance vis-à-vis conventional finance in other countries become irrelevant. For example the country has a unitary Islamic legal and regulatory framework and has adopted AAOIFI and IFSB standards for its financial sector. However, while the some of the infrastructure institutions (such as legal, regulatory, Shariah governance, and information infrastructure) are sound, there is still a need to develop robust liquidity, consumer protection, financial literacy and human capital development frameworks for the industry.

Chart 4.10: Islamic Financial Architecture Institutions—Sudan



4.11. Turkey

After the initiations of the economic and financial liberalisation programmes in 1980, the initial institutional approach for the development of Islamic banking, which is called ‘participation banking’ in Turkey, matured in 1983 with the issuance of a government decree that allowed the establishment and operation of Islamic financial institutions (IFIs). Consequently, in 1985, the first Islamic financial institution, namely Albaraka Turk, started to operate leading to the creation of other IFIs. However, the institutions were called ‘Special Finance Houses’ (SFHs), which meant that they were not legally ‘banks’, and hence they were not subject to the legal framework applied to banks and could not benefit from the facilitatory opportunities of the financial system.

In furthering liberalisation and consolidating the economy and financial sector over the years, a number of regulative and legal changes and amendments have taken place which has also shaped the development trajectory of Islamic banks as well. In 1999, Banking Law amended and SFHs were included in the Banking Law. However, the main development has been the elevation of the status of SFHs into bank with the title of ‘Participation Bank’ in 2005 through the new Banking Act No. 5411 of 2005. This implies that Islamic banks are now subject to the same regulations and legal forms in their dealings as their conventional counterparts.

Participation Banks Association of Turkey (PBAT), an industry trade association, plays an important role in promoting the interest of the Islamic banks in Turkey. Regulations require every participation bank to become member of the PBAT. It was founded as the SFH Association with a Cabinet Decision in 2001 parallel to the Banking Association of Turkey, which serves for conventional banks. SFH Association was transformed into PBAT after the status of SFHs was elevated to ‘Participation Bank’ in 2005 and given a new mandate and form with a Cabinet Decree in 2006. From 2006 onward, the institutions intending to get a license to open a participation bank were obliged to become a member of the PBAT within one month from the receipt of permission, according to the above-mentioned cabinet decree published in the Official Gazette dated February 28, 2006. One of the aims of PBAT is to work for the advancement of the industry.

BRSA (Banking Regulation and Supervision Agency) and PBAT developed a report in July 2014 after ‘*The Participation Banking and Interest-Free Finance Workshop*’ and it has become one of the essential steps for the development of the sector. In following up recommendations of the Report, PBAT published its strategic vision (in consultation with the relevant authorities) in 2015 titled as ‘*Turkey Participation Banking Strategy Document, 2015-2025*’. The document outlines a number of strategies, actions, and responsible and relevant institutions are identified in order to develop an effective system of ‘completing the identified tasks’ for the development of the industry.

In addition, the recognition of the importance of participation banking and finance resulted in having “Strengthening Interest-free Finance and Participation Banking” component added into Istanbul International Financial Centre Program Action Plan that was published with the decision of High Planning Council on 16/02/2015 (Yabanli, 2016). All these efforts have culminated into establishment of a steering mechanism, namely ‘Interest-Free Finance Coordination Board’ that was established by The Prime Ministry Circular on 15th December 2015. “The goal of the Board is to advance sound participation banking and participation

insurance as well as interest-free finance system in general, and to contribute to Turkey's vision of becoming an international finance center" (Undersecretariat of Treasury, n.d).

Such proactive approach to participation banking in Turkey brought with it the formation of two state owned participation banks. In addition to four private participation banks (Albaraka-Turk, Kuveyt-Turk, Turkiye Finans and Bank Asya), Ziraat Participation Bank was established by Ziraat Bank as a subsidiary in 2015 and Vakif Participation Bank, owned by the Directorate General of Foundations (Awqaf), has recently been established in 2016 as state-owned participation banks.

The total banking assets in the country were USD 813.4 billion, of which the participation banking assets were USD 41.4 billion in 2015, which amounts to about 5.1% of total banking assets (TKKB, 2015). This implies that the total assets of participation banks in the financial system of Turkey was 5.1% in 2015 with a 28.5% CAGR (compounded annual growth rate) from 2005 to 2015 while in the same period the CAGR of conventional banking sector was 19.4%. Despite the higher growth rate of participation banks in Turkey, their share remains around the same figure over many years, which is much lower than the corresponding figures in Malaysia (around 25%) and the GCC countries. However, recent reforms and developments are expected to increase the share of participation banking in the financial system in Turkey and increase the presence of Islamic finance including *sukuk* issuances. The developments in Islamic capital markets are expected to be more positive with increasing corporate and sovereign *sukuk* issuances since 2010.

4.11.1. Legal Infrastructure

Supporting Islamic Finance Laws

In examining the legal developments in relation to the Islamic banking and finance provision in Turkey, as part of the economic and financial liberalisation policies of the early 1980s, the then incumbent Özal government issued the Cabinet Decree of 83/7506 on 16/12/ 1983 to establish SFHs. After the provision of the necessary by-laws, Albaraka-Turk started to operate as the first SFH in Turkey in 1985, a number of other SFHs followed the suit.

The 1994, the currency crisis and its impact on the banking sector with bank failures implied the necessity of more robust financial regulation. Therefore, the SFHs were brought under the existing Banking Law No. 4389 in December 1999, which implied the extension of all the relevant regulations for SFHs. In responding to the failure of Ihlas SFH in 2001 as a consequence of the financial crisis, and its impact on the depositors, SFHs became subject to 'guarantee scheme', as applied to conventional banks, with the amendment made to the Banking Law No. 4389 in May 2001 SFH Assurance Fund" was established within SFH Association (which is now known as PBAT). This implied that "special current accounts and profit/loss participation accounts of natural persons ... defined as deposits to be insured" (Okumus, 2005: 56).

The existential development took place in 2005 with the new Banking Act No. 5411 issued on 01/11/2005, which ended the duality in the banking sector in Turkey by changing the status of SFHs to 'Participation Bank'. Together with conventional banks, participation banks have been provided a new 'guarantee scheme' under the re-organised SDIF (Savings Deposit Insurance Fund), which annulled the previous regulation. With Banking Act no.5411 of 2005, "SFH

Assurance Fund” was transferred to the SDIF. In addition, BRSA with its new legislation became the sole regulative authority for both conventional banks and participation banks in 2005, which “overcame the duality observed in the legal, regulative and operative framework of these banks since their inception in 1985” (Asutay, 2013: 215). The Banking Act No. 5411 of 2005 brought participation banks under its umbrella and provided unitary and fair playing field by enabling participation banks to have the same privileges and status as conventional banks.

As regards to *takaful* provision, regardless of whether the institution is Islamic or conventional, all insurance companies are subject to the provisions of the Insurance Law (Batur, 2014).

Legal developments in Islamic financial service provision continued with the issuing of a Communiqué by the Capital Markets Board (CMB) to facilitate the *ijarah sukuk* on 01/04/2010, which led to the first *sukuk* (off-shore) issued by Kuveyt-Turk in 2010. An amendment to tax law in February 2011 provided tax neutrality for *ijarah sukuk*. Hence, after the necessary tax regulations, the first domestic corporate *sukuk* was issued in October 2011 by Kuveyt-Turk. In June 2012, an amendment for Public Finance and Debt Management Law No. 4749 provided the necessary legislation for sovereign *sukuk* resulting in the first sovereign *sukuk* issues by the Republic of Turkey on 18/09/2012 in domestic and international capital markets. “The amendment of the financial bill in February 2011 also ratified the ‘Treaty for Founding the Islamic Corporation for the Development of the Private Sector’, initiated by the Islamic Development Bank to promote economic growth in the member countries through Islamic finance” (Asutay, 2013: 216). A new Communiqué from the CMB of Turkey on 07/06/2013, which regulates *Sukuk* issued based on ownership, management agreement, trading, partnership, engineering, procurement and construction contract and combined use of listed, as well as other types of *Sukuk* which are accepted by CMB whereby Islamic capital market sphere was facilitated with new instruments.

In consolidating the institutional development, on 06/01/2011, Borsa Istanbul (Istanbul Stock Exchange) “launched the Participation Index for Islamic banks, known as KATLM, which operates through industrial and financial *Shari’ah* screening” (Asutay, 2013: 216). Moreover, on the collective investment schemes side, the legal framework for participation funds has been established. Consequently, Islamic collective investment schemes have been established in Turkey in the form of participation funds.³⁴

Tax regimes and impact on Islamic finance

Participation banks faced challenges in their operations from the tax system, as Islamic finance transactions can involve a number of sales contracts within one particular transaction. A particular issue is VAT, as VAT has been in operation in Turkey since the early 1980s, which implies that one Islamic financing transaction may incur a set of VATs. Similar to other jurisdictions, Turkey provided tax neutrality in making sure that the operations of participation banks should have a (relatively) fair playing ground, which has been possible by subjecting individual transactions to tax rather than levying tax on each of the contracts

³⁴ Communiqué on Principles of Investment Funds (III-52.1)
<http://www.cmb.gov.tr/apps/teblig/displayteblig.aspx?id=498&ct=f&action=displayfile>

involved in one particular transaction whereby multiple VATs were ruled out. In addition, as a consequence of gaining 'bank' status with the 2005 Banking Law No. 5411, their transactions were exempted from the VAT and they became subject to Bank and Insurance Transactions Tax.

While *ijara sukuk* issuance became possible with legal development in April 2010, tax related issues made the issuance of (domestic) *sukuk* issuance disadvantageous. In February 2011, Law offering tax amnesty, No 6111, was enacted to facilitate *ijara sukuk* by "reducing the withholding tax on such *sukuk* [structures] to 10% and exempting sales from value-added, stamp and corporate taxes... Further legislation includes the exemption from taxes on revenue for *sukuk* certificates with a minimum tenor of five years. Certificates with shorter tenors would still be subject to tax, ranging from 3% to 10% (Thomson Reuters, 2015: 94). Accordingly, through such amendments, *ijara sukuk* transactions are exempted from "value added tax, stamp duties, corporate tax, title deed registration fees, and notary public fees. The withholding tax on *sukuk* was reduced to 10%. Further measures exempted *sukuk* with tenors in excess of five years from taxes on revenue" (Thomson Reuters, 2015: 91). In proactively encouraging the expansion of the *sukuk* market, a number of favourable tax treatments and certain tax exemptions are provided for *sukuk* issuance by the amendments of the Turkish tax legislation impacting the Corporate Tax Law (Law No 5520), VAT Law (Law No 3065), Charges Law (Law No 492), Income Tax Law (Law No 193), Stamp Tax Law (Law No 488). Hence, tax amendments have facilitated the *ijara sukuk* with the first domestic *sukuk* being issued on October 2011 by Kuveyt Turk Bank.

It is true that with the necessary amendments, *ijara sukuk* is exempted from double taxation and is provided with the above mentioned other tax incentives. In recent legislation on 9th August 2016, a similar facilitation was extended to other *sukuk* structures. However, it should be noted that "the application of revenue taxes of 3% to 10% to short-term *sukuk* remains a constraint on the growth of that market segment" (Thomson Reuters, 2015: 91).

Dispute Settlement and Conflict Resolution Framework and Institutions

Being a secular country with civil law, Turkey, by definition of the constitution, is not able to provide any specific *Shari'ah* provision for legal matters and disputes. Therefore, similar to disputes in other business and commercial activity, Islamic finance related disputes are dealt with at the civil courts within the remits of legal provisions of the country where the cases are adjudicated.

In an attempt to become a global financial centre in line with the İstanbul International Financial Center Program, Turkey aims to make Istanbul as an Arbitration Centre for which the Law on the Istanbul Arbitration Centre (Law No. 6570) was issued in the Official Gazette on 29/11/2014. By becoming effective on 01/01/2015, the law established Istanbul Arbitration Centre (ISTAC).

In recent years, Turkey has undertaken a number of law reforms to provide a modern and dynamic arbitration system, for which UNCITRAL Model Law has been adopted and certain amendments were introduced to the Turkish Constitution. For example, Article No 125 of the Constitution was amended to allow for the arbitration of large-scale concession agreements (Levush, 2014). The issuance of the International Private and Procedure Law (IPPL), No. 5718 on 12/12/2007, and the International Arbitration Law (IAL), No. 4686 on 21/06/2001

provided the necessary foundation for a robust arbitration system for international disputes in the country. This has been strengthened by the ratification of a number of international conventions and treaties in the field, which includes: the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, the European Convention on International Commercial Arbitration, and the Convention on Settlement of Investment Disputes between States and Nationals of Other States (Levush, 2014).

For domestic disputes, The Code on Civil Procedure (CCP), No. 6100, issued in the Official Gazette on 04/02/2011 makes provisions for the arbitration of disputes involving no foreign element and originating within the country (Demirci, 2015).

The main arbitration organisations in Turkey are Istanbul Chamber of Commerce (ICC), Union of Chambers and Commodity Exchanges of Turkey (UCCE), International Chamber of Commerce Turkish National Committee (ICCTNC), and the recently established Istanbul Arbitration Centre (IAC). As identified in the relevant law, IAC's remit includes setting the rules for arbitration and alternative dispute resolution methods and carrying out related services and co-operating with foreign and local persons and entities related to arbitration and alternative dispute resolution methods. It should be noted that these organisations have their own rules for arbitration at both domestic and international level.

Islamic finance related disputes and arbitrations in Turkey, as part of commercial and business activity, are subject to the same regulation, law and procedures as conventional finance.

Bankruptcy and Resolution of Banks

The Financial Safety Net brings together the main financial entities in Turkey: BRSA, CBRT (Central Bank of Republic of Turkey), Undersecretariat of Treasury, CMB (Capital Markets Board) and SDIF (Savings Deposit Insurance Fund), which is also charged with handling resolution matters (Kucukoglu Keles, 2013). Although protection of savings deposit in Turkey can be traced back to a particular law originating in 1933, "Banks Liquidation Fund" was founded in 1960 and the SDIF was established in 1983 within the body of Central Bank of the Republic of Turkey. The SDIF has achieved an autonomous status by the Law No: 5020 in 2003, while BRSA was established in 31/08/2000 as the sole regulative authority of the banking and financial institutions.

As regards to the legal framework for Financial Safety Net, three entities are mentioned (Kucukoglu Keles, 2013): the Coordination Committee working according to Banking Law No 5411 (Article 100), the Financial Sector Committee operating according to Banking Law No 5411 (Article 99) and the Financial Stability Committee operating according to the Law on the Structures and Duties of the Undersecretariat of Treasury (No. 4059, Additional Clause 4). The objective of these entities is to promote information sharing, cooperation and coordination among institutions towards ensuring confidence, stability and development of the financial markets.

BRSA Supervision can determine if there is a need to intervene. This intervention is possible according to Banking Law No. 5411 (Article 67) in relation to the following (Kucukoglu Keles, 2013): Maturity Gap between assets and liabilities; incompliance with the provisions pertaining to liquidity; insufficient profitability to reliably perform its activities; insufficient capital adequacy; deterioration in the quality of the assets that will weaken the financial

structure; violation of Banking Law and the applicable regulations; and inefficient internal audit, internal control and risk management systems. Accordingly, as part of the intervention process, Banking Law No. 5411 Article 68 suggests 'corrective measures', Article 69 suggests 'rehabilitating measures', Article 70 requires 'restrictive measures', and in the end Article 71 involves the BRSA Board Decision to revoke the operating permission of the bank or to transfer the management and control of the bank to the SDIF along with its shareholders' rights except dividends without revoking its operating permission.

In the case of a bank failure, if the BRSA Board decides to proceed under the Article 106 of the Banking Law No. 5411, the SDIF immediately starts to pay out the insured deposits, including the insured participation funds, and subsequently applies the bankruptcy and liquidation procedures and processes. The payout period (reimbursement to the depositors) is defined as three months from the failure of the bank which can be extended 3 months up to 1 year with the decision of SDIF Board. However, if the BRSA Board decides to transfer the shareholder rights (except dividend) and management and control of a bank to SDIF, according to Article 107 Banking Law No. 5411, the SDIF initiates bank resolution process. In the resolution process, SDIF has the authority to suspend banking activities temporarily. After that SDIF has three types of resolution options: The first option is to ask BRSA directly to revoke the license of the bank if the SDIF determines that the bank is totally insolvent and there is nothing to be done. The second option is to take over the shares in return for bank losses. Within this framework, SDIF resolves the banks through merger & acquisition of banks or sale of bank shares or sale of assets and liabilities separately. In order to restructure or clean the bank, non-performing loans and other assets can be transferred to the SDIF, bad bank or Asset Management Company. And the third option is to make purchase and assumption. In this option, SDIF is authorized to sale assets and insured deposits of the failed bank without taking over the shares and then to ask BRSA to revoke the banking operation permission of the bank. It should be noted that participation banks are subjected to same bankruptcy and resolution norms and processes as conventional banks as described above. In particular, failure of Ihlas Finance in 2001 during the financial and currency crisis in Turkey alerted the financial authorities of the importance of deposit insurance scheme for then the SFHs, and therefore, they were immediately brought under the umbrella of a deposit insurance scheme. The "SFH Assurance Fund" was established within the SFH Association in 2001 in order to insure special current accounts and profit/loss participation accounts. With the new Banking Act No. 5411 of 2005, the status of SFHs was changed to 'Participation Bank' and "SFH Assurance Fund" was transferred to the SDIF so SFHs have become subject to the bankruptcy and resolution processes under the operation of SDIF.

Turkey has gained significant experience of resolving banks during 1994 currency crisis and 1999 and 2000-01 financial and currency crisis with large number of failed banks going under administration. While Turkey has not experienced any bank failures during the period of 2003-2014, management and control of the Bank Asya was transferred to the SDIF in 2015 and the operating licence of this bank was revoked on 22nd July 2016.

4.11.2. Financial System Regulation and Supervision Framework

A number of regulative agencies have been important stakeholders for the development of Islamic banking sector in Turkey. BRSA is the main authority in charge of regulation and supervision of the banking sector, which was established in 31/08/2000 with the objective of ensuring stability, safeness and soundness of financial markets in Turkey; to protect the rights

of account holders and ensure an effective operation of loan and credit system; and to ensure the confidence and stability in financial markets. In addition, BRSA is tasked with “regulating, enforcing and ensuring the enforcement thereof, to monitor and supervise the implementation of establishment and activities, management and organizational structure, merger, disintegration, change of shares and liquidation of banks and financial holding companies as well as leasing, factoring and financing companies without prejudice to the provisions of other laws and related legislation” (Gecer and Teker, 2011). Thus, BRSA provides “a single integrated regulatory framework applied to all banks with references identifying provisions applying specifically only to Islamic banking and banks” (Song and Oosthuizen, 2014: 13).

As in single regulative regime, the supervision of all banks including Islamic banks are subject to BRSA, as the single supervisory authority.

As regards to *takaful* provisions in Turkey, the Undersecretariat of Treasury is the only regulatory and supervisory authority along with conventional insurance (Batur, 2014). It should be noted that sovereign *sukuk* is issued by the Undersecretariat of Treasury and regulated by CMB.

As the third regulatory body, the CMB of Turkey is the regulatory authority for stocks in general and the Participation Index at the Borsa Istanbul; corporate *sukuk*, and collective investment schemes including pension funds (Şagar, 2013).

To provide co-ordination among various regulatory and related bodies, the Financial Stability Committee was established in 2011 with the objective of “identifying and mitigating emerging systemic risk, to coordinate policy actions, and to better integrate micro- and macro-prudential perspectives among institutions” (Batur, 2014). The Financial Stability Committee is comprised of the Undersecretary of Treasury, The Governor of CBRT, The Chairman of BRSA, The Chairman of CMB, The Chairman of SDIF under the chairmanship of Deputy Prime Minister for Economic and Financial Affairs responsible for the Undersecretariat of Treasury.

As regards to Capital Adequacy Framework, the BRSA follows the BCBS regulatory framework for minimum capital adequacy under the Basel II and Basel III standards for all banks including participation banks, which became compulsory for the banking sector since September 2013 while BASEL II has been valid since July 2012 (Thomson Reuters, 2014). Accordingly, “the regulatory framework contains a single set of capital adequacy requirements, which are applicable to all banks. Thus, no distinction is made between the capital requirements that apply to Islamic banking/banks and conventional banking/banks” (Mejía *et al.*, 2014: 18). Although, In Turkey, the BRSA determines CAR for all banks including participation banks as 8% (Thomson Reuters, 2014: 63), CAR for Turkish banking sector was 15.5% as of December 2015.

4.11.3. Shariah Governance Framework

Being a secular country, *Shari’ah* formally does not have any legal implications in Turkish law despite the fact that in everyday life individuals make references to *Shari’ah* in shaping their religious practice. The Presidency of Religious Affairs under the Prime Ministry operates a Fatwa Council to respond to the arising issues including individual queries, which include commercial, business and finance related matters also. However, their judgements do not have any formal implications on the operations of participation Banks in Turkey.

Since there is no particular law for participation banks in Turkey, there is no provision for *Shari'ah* boards and *Shari'ah* governance either. The existing Banking Law No. 5411 and the regulation provided by BRSA do not incorporate and include *Shari'ah* governance or supervision. Therefore, there is no legal requirement for Islamic banks to establish *Shari'ah* boards in ensuring *Shari'ah* compliancy (Thomson Reuters, 2014: 115). However, all the participation banks in Turkey have their own individual *Shari'ah* board as an advisory and supervisory body. Therefore, they do not appear in the governance structure of participation banks nor do they issue the annual *Shari'ah* Supervision Reports. This is an important shortcoming in terms of disclosure for Islamic banks as identified in AAOIFI standards.

Since there is no provision regulating the *Shari'ah* boards or recognising them as part of the governance system, there are no limits in terms of the maximum and minimum numbers of *Shari'ah* scholars can sit at each of the *Shari'ah* boards operating in every participation banks in Turkey (Thomson Reuters, 2014: 115). The members for the *Shari'ah* boards are drawn by each participation banks from leading religious scholars, academic or otherwise, who have special interest in *muamalat* or Islamic financial transactions. The decisions of the Fatwa Council of the Presidency of Religious Affairs are not legally binding or institutional.

Istanbul International Financial Center Program Action Plan also identified the importance of establishing *Advisory Boards* as well as the *Turkey Participation Banking Strategy Document, 2015-2025* (PBAT, 2015), which essentialised the establishment of a *General Advisory Board* and making the presence of *Advisory Board* in participation banks as a standard (PBAT, 2015, 53). In support of this, BRSA has also raised similar expectations after it engaged with Islamic banking and strengthened its structure by forming a separate department.

4.11.4. Liquidity Infrastructure

Compared to countries such as Malaysia, Turkish Islamic banks do not have a particular liquidity infrastructure to facilitate their liquidity management. Conventional instruments for liquidity management, such as interbank market, secondary market financial instruments and facilities from the central bank as the lender of last resort ease the liquidity tensions and helps to effectively manage their liquidity. However, due to *Shari'ah* compliancy, such instruments and mechanism are not available for Islamic banks.

In responding to the problem in the global level, the International Islamic Liquidity Management Corporation (IILM) was established on 25/10/2010 by a number of countries including Turkey as a stakeholder. As an international organization intending to support cross-border liquidity management, IILM, aims to provide liquidity needs of Islamic banks and financial institutions in times of financial stress, which is also available for Turkish Islamic banks also.

In facilitating the liquidity management of Islamic banks in Turkey, “the Undersecretariat of Treasury started the issuance of Revenue Indexed Bonds (RIB), which are purchased by the participation banks” (Yilmaz, 2011) too for ease of their liquidity, and this was available between 2009-2012, although since 2012 the treasury has not issued any RIB. However, with the legislation and provision of *sukuk* in 2011, *sukuk* has been an important instrument for liquidity management for participation banks in Turkey and elsewhere.

Traditionally, the reserve requirement ratios are important monetary policy instruments for central banks. In line with the new strategy that took effect in the last quarter of 2010, the CBRT, the Central Bank of the Republic of Turkey, developed a new policy framework towards reducing macro financial risks within the limits of a favourable inflation outlook. Accordingly, in addition to the traditional policy instrument of the one-week repo auctions rate, reserve requirements were introduced as an active tool.

The CBRT defines and calculates reserve requirements for a number of liabilities for banks including participation banks, which includes ‘deposits and participation funds’ (CBRT, n.d.).

As part of liquidity adequacy, participation banks in Turkey “are required to calculate, maintain and report the liquidity sufficiency according to the procedures determined by the BRSA and the Central Bank” (Thomson Reuters, 2014: 63). It should also be noted that in response to bringing the liquidity coverage in line with Basel III standards, “the BRSA introduced liquidity coverage ratios (LSR) in the Turkish banking sector to ensure that banks have sufficient high-quality liquid assets (HQLA) to survive a significant, unexpected cash outflow for up to 30 days. The LSR is a ratio of HQLA to total net cash outflows over a 30-day stress period – i.e., total expected cash outflows less total expected cash inflows subject to a cap of 75% of total expected cash flows” (Matthews and Keskin, 2015). This demonstrates the BRSA’s commitment to a robust and resilient Turkish banking sector including participation banks.

4.11.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency and Disclosure

In Turkey, accounting standard setting institution is the POA (Public Oversight, Accounting and Auditing Standards Authority), which was established on 02/11/2011 by Decree Law No. 660 and replaced the Turkish Accounting Standards Board (TASB). It is “the authority to set and issue Turkish Accounting Standards compliant with the international standards, to ensure uniformity, high quality and confidence in statutory audits, to set the auditing standards, to approve statutory auditors and audit firms and to inspect their audits, and perform public oversight in the field of statutory audits” (POA Website, n.d.). It sets the accounting standards that are fully compliant with the International Financial Reporting Standards (IFRSs) (POA, 2015), and this is partly due to the EU accession process which requires also the harmonisation of accounting standards. Since the CMB is authorized on determining the conditions of independent auditing activities of institutions and corporations within the scope of capital market law, related with auditing of publicly traded companies, additional conditions can be requested from independent audit firms authorized by the Public Oversight Accounting and Auditing Standards Authority.

In line with EU laws and regulations associated with accounting practices, “in the Turkish Commercial Code published in 2012, all companies have become obligatory to apply accounting rules set by the POA and the POA is authorized to determine scope of the application of Turkish Accounting Standards, which are in fully compliance with the International Financial Reporting Standards. In line with EU practices, the POA has made mandatory to apply Turkish Accounting Standards for public interest entities” (POA, 2015: 44).

In viewing the development and sophistication in Islamic finance transactions, POA is now considered as insufficient for the needs of the Islamic finance industry in Turkey (PBAT, 2015: 40). For this PBAT (2015) suggests the formation of a team within POA versed in Islamic finance related accounting and standard needs so that specific accounting standards can be set for a robust development of the industry.

BRSA, as mentioned, is “the authority over the inspection of statutory auditors within banking sector. Auditing of the banks is considered as regulated through based on Banking Law No. 5411 in current situation” (POA, 2015: 45). This applies to participation banks as well. Requirements on auditing with respect to capital market institutions and publicly held firms (with the exception of publicly held banks and insurance companies) under the Capital Markets Law are determined by the Capital Markets Law as well as the Communiqués of the CMB.

In Turkey all banks, including participation banks, are subject to the same disclosure requirements, which stems from the Banking Law and other related regulations, CMB Law and Related Regulations, and its corporate governance policies, Commercial Law, Regulation of Borsa Istanbul and other related legislations, and POA’s requirements.

Rating Agencies

There are nine rating agencies operating in Turkey, three of which are international rating agencies recognised by the CMB.³⁵ The regulation of financial market rating activities is regulated by CMB and BRSA. CMB’s jurisdiction in regulating the rating activities is related to capital markets in relation to credit rating and corporate governance compliance. On the other hand, BRSA’s regulation on authorisation and activities of Rating Institutions was recently amended. The amendments as published in Official Gazette No. 29599, which came into effect on 31/03/2016, aim at ensuring “the independence and neutrality of credit rating activities. Regulatory changes also address credibility and reliability checks, exemptions for international credit rating agencies in Turkey, rating methodologies, as well as notice submissions” (Moroglu and Aydin, 2016, February 03). It should be noted that one of the limitations of issuance of *sukuk* in Turkey is the lack of credit ratings (TR and IRTI 2014:92). However, recently Turkey has issued international *sukuk* rated by international rating agencies such as Fitch and Moodys.³⁶

³⁵ See: CMB Website: <http://www.spk.gov.tr/indexcont.aspx?action=showpage&showmenu=yes&menuid=6&pid=10&subid=1&submenuheader=10>

³⁶ See <http://www.reuters.com/article/idUSFit961629> and https://www.moodys.com/research/Moodys-assigns-PBaa3-rating-to-Turkeys-sovereign-sukuk--PR_283649

4.11.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

In responding to the harmonization requirements of the EU accession process, and also in taking account the new Turkish Law of Obligations and Turkish Trade Law, a new Consumer Protection Act (No. 6502) was issued on 28/11/2013, which became effective from 28/05/2014.

The new Consumer Protection Act has implications, among others, for Consumer Credit Agreements and Credit Cards and Long-distance Finance Transactions in the sense of distribution of financial service by means of distance communications. Financial services include banking transactions, loans, insurances, private pension plans, money investments or payment services (BRSA, 2014 November; Lachman *et al.*, 2014). These amendments also have implications for Islamic banks at least in terms of consumer loans and financial leasing.

'Financial Access, Financial Education, Financial Consumer Protection Strategy and Action Plans', which was prepared by Financial Stability Committee, was issued as Prime Ministry Circular No. 2014/10 on 05/06/2014. The primary objective of the Strategy are to extend financial products and services to all segments of the society, include outsiders of the financial system and increase the quality and use of existing products and services by increasing knowledge and awareness. Furthermore, the Strategy aims to ensure that efficient measures are taken by the regulatory bodies for the protection of financial consumers. It contains two action plans for financial education and financial consumer protection with fifty-five concrete actions in total covering 2014-2017. The 'Financial Education Action Plan' will be monitored and coordinated by the CMB, and the 'Financial Consumer Protection Action Plan' will be monitored and coordinated by the BRSA. The Undersecretariat of Treasury will be responsible for overall coordination of the strategy and monitoring the implementation.

In realising the action plans, the action plan is proactively implemented by responsible and coordinator agencies. As part of such actions, mandatory personal finance lessons for students are introduced in pilot areas with the objective of increasing financial literacy, and educational programmes and research has been conducted by CMB. It has recently been announced by the government that CMB will host an interactive website to contribute to financial education and financial literacy (Akyil, 2016, May 8). Islamic banking and finance is also included in such strategies and action plans.

Private sector initiatives have also been taken by various stakeholders, such as '3Kumbara (PennyBank)', whose "Literacy Education Program incorporates activity-based methods that support the development of active learning, based on social constructivism" (3Kumbara, n.d.).

Deposit Insurance

The Turkish banking system has always had deposit insurance since early 1930s. SDIF (Savings Deposit Insurance Fund) was established in 1983 (with the Decree of Law on Banks No. 70) with the objective of insuring the savings deposits in the banks. The duty of administration and representation of the SDIF were transferred to the Banking Regulation and Supervision Agency by the Law No. 4389 in 1999. After a number of administrative and legal changes, with the amended acts, SDIF gained an autonomous status by the Law No.5020 in

2003. The new Banking Law No. 5411 of 2005 maintained the administrative and legal statue of the SDIF.

As mentioned, from its first institutionalisation in 1983 until 2001, participation banks which were classified as SFHs and did not benefit from the deposit insurance facilities. However, the failure of Ihlas SFH in 2001 alerted the authorities of the importance of including Islamic banks within the deposit insurance scheme.

In responding to the failure of Ihlas Finance in 2001 as a consequence of the financial crisis, and its impact on the depositors, which created new social problems, SFHs became subject to 'guarantee scheme', as applied to conventional banks. With the amendment made to the Banking Law No. 4389 in May 2001, SFH Assurance Fund within SFH Association was established in a *Shari'ah* compliant manner. This implied that "special current accounts and profit/loss participation accounts of natural persons ... defined as deposits to be insured" (Okumus, 2005: 56). By acquiring Participation Bank status with the new Banking Act No. 5411 in 2005, participation banks have been brought under the umbrella of a new 'guarantee scheme' under the SDIF together with other banks. It should be noted that SFH Assurance Fund worked in *Shari'ah* compliant manner, while the current guarantee scheme under SDIF works in conventional terms. While this poses a dilemma, a survey of the countries with Islamic finance presence demonstrates that except for Malaysia and Sudan, other countries including Turkey provide deposit insurance and guarantee under the conventional system (Li, 2016: 11).

4.11.7. Human Capital and Knowledge Development Framework

In recent years, a number of academic and professional programmes have been initiated in Turkey to respond to the increased Islamic finance activity. This has been the result of the 2013 'Workshop on Participation Banking and Interest-Free Finance', jointly organised by BRSA and PBAT, which covered 'Education, Human Resources and Certification' as one of the nine areas or chapters of development. The Report developed from the workshop identified and developed a number of strategies and actions to develop education and human resources needs of the industry, which are as follows (BBDK and PBAT, 2014: 31-34): development of master and PhD programmes in Islamic economics and finance, undertaking measures to develop academic staff teaching and researching in Islamic finance, developing networks between academics teaching and researching in Islamic finance, taking necessary measures to develop literature in Turkish in Islamic finance and also developing textbooks in Islamic finance, establishing of research centres and institutes, developing domestic certification programmes, developing on the job training and internship opportunities, and develop opportunities for the use of educational technologies for effective skill development. Furthermore, the number of Islamic economics and finance master programmes being undertaken and also the existence of the two private universities being licenced to commence their undergraduate degrees in Islamic economics and finance since October 2016 should be taken as an indication of the importance attached to the recommendations of the Workshop.

In further pinpointing the strategy development in line with the recommendations from the Workshop, in PBAT's 2015 Strategy Document, education, training, and certification related areas are also critically developed and the relevant institutions and agencies were identified for the tasks described (PBAT, 2015: 55-61).

With the support of the relevant institutions, PBAT and the administration, a number of universities have developed Islamic finance master and PhD programmes, which includes Sakarya University, Istanbul University and Sabahattin Zaim University. Other universities have also taken initiatives to develop various programmes. In this regard, KTO Karatay University has opened Islam Economics and Finance bachelor degree program for the first time in Turkey (<https://goo.gl/iCufnx>). The Higher Education Council has been positive in facilitating such programmes through the approval process, while research funding institutions such as TUBITAK have been positive in funding Turkish academics for their Islamic finance related research in overseas countries. With such positive developments, a large number of academics have slowly moved into researching Islamic finance. Furthermore, a number of technocrats and academics have been to Malaysia for academic and professional training and research activities. Moreover, establishment of World Bank Global Research Centre in Istanbul in 2013 has been contributing to the development of academic and professional research base in Turkey. Lastly, in recent years, a number of academic conferences has been organised in Turkey whereby Turkey is now well located in the Islamic finance academic and education map.

A number of initiatives have also been taken to develop talent and professionalism through various certification programmes either through individual initiatives or institutional initiatives. Turkish Islamic banks have come out strongly in support of professional certification as well as academic programmes, and have encouraged their staff to register to such programmes.

4.11.8. Summary and Conclusions

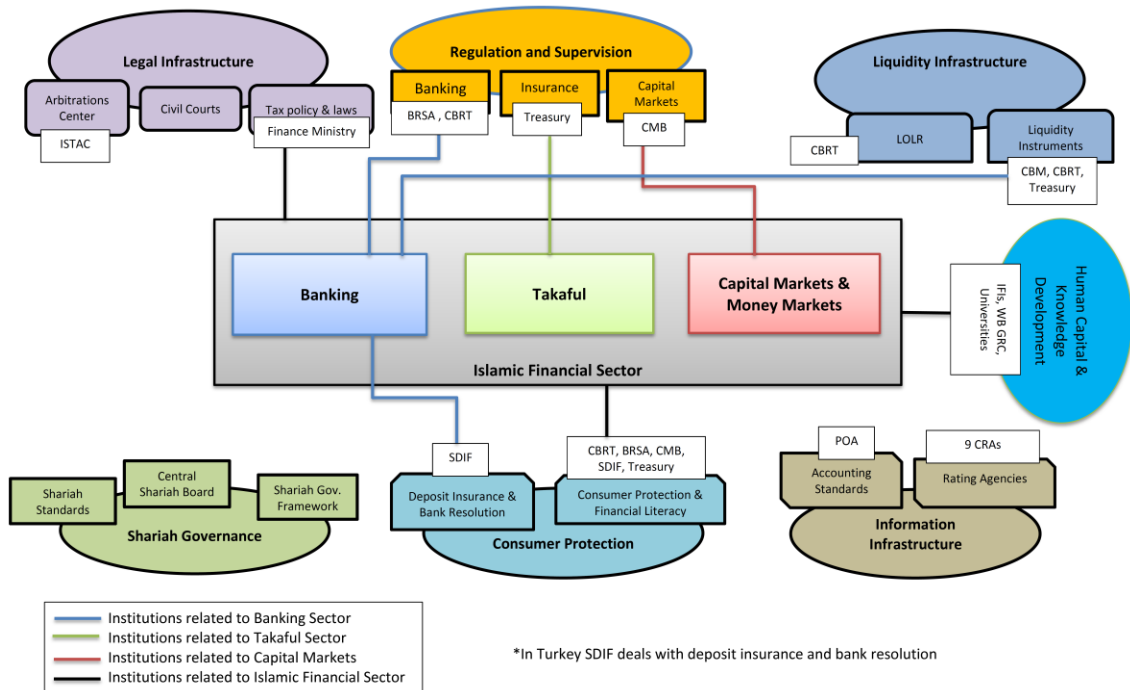
Turkey is the second largest economy in the Muslim world with huge potential to be a regional economic leader, and this potential is also true for Islamic finance. However, due to a number of institutional barriers, until recently the potential of Islamic finance in Turkey has been sluggish. With the new institutional identity being transferred from SFH into banks with the Banking Law of 2005, Participations Banks have gained full recognition, and this has affected their performance in a positive manner. The development of participation banking has been relatively better with five participation banks claiming about a 5% market share in the banking system.

The proactivity of the government indicates the essential importance given to the development of the industry. Such positive change is reflected in the establishment of two state-owned Islamic banks, Ziraat Participation Bank and Vakif Participation Bank, which were licensed in 2015 and 2016 respectively. It is worth noting that all stakeholders play important roles in framing necessary policies and strategies related to the development of participation banking in the country, which is evidenced also by the formation of a particular secretariat within the President's Office in late 2015 to coordinate the policies towards Islamic banking in Turkey. The suggestions made in the 2013 Workshop report have been essential in developing the necessary policies to provide a fair playing field for Participation Banks in Turkey.

Participation based financial development is now considered as an essential component of Istanbul International Financial Center Program. Therefore, a number of academic, professional and training programmes have been initiated in the country.

Overall, participation financial development appears to have a growth potential in Turkey. However, the share of participation banks in the financial system is still a concern, as the question remains on whether they will be able to take the next step of expansion within the capacities and financial architecture such as Shariah governance framework and liquidity infrastructure they have.

Chart 4.11: Islamic Financial Architecture Institutions—Turkey*



4.12. United Arab Emirates (UAE)

The United Arab Emirates (UAE) is host to the Dubai Islamic Bank, the first Islamic bank established in 1975. Since then, Islamic finance has witnessed tremendous growth in the country making it one of the dominant markets for Islamic finance. Currently the country has a total of 44 Islamic financial institutions (excluding takaful) which includes 8 fully-fledged banks, 23 Islamic windows, 12 finance companies and one investment company (CBUAE 2104: 67). Islamic banking assets valued at USD 136 billion constitute 21.6% of the total banking assets in the country and 15.4% of the global Islamic banking assets (CIBAFI et. al 2015: 18; EY 2016: 52). From a total of 60 national and foreign insurance companies operating in the country with a total premium of USD 9.128 billion in 2014, 11 are takaful companies with contributions of USD 1.314 billion constituting around 14.3% of the total premiums (Hodgins 2015). UAE also plays a key role in sukuk issuances. UAE issued 68 sukuk during 2001 to 2014 raising USD 45.986 billion constituting 39.35% of the value of global sukuk issues (IIFM 2014).

Other than the domestic financial market, UAE also hosts two free international markets: the Dubai International Financial Centre (DIFC) and the Abu Dhabi Global Market (ADGM). DIFC is a financial free zone located within the emirate of Dubai. The DIFC has been in existence since 2004. There are approximately 500 entities either incorporated or registered within the DIFC (Khan and Walker, 2010). DIFC has its own body of laws which are completely segregated from the laws applicable across UAE. DIFC also has its own court system and its own regulator, the Dubai Financial Services Authority (DFSA) (Khan and Walker, 2010). DFSA also regulates the offshore NASDAQ Dubai. Abu Dhabi Global Market is a broad-based international financial centre for local, regional and international institutions that was established in 2013. ADGM hosts three independent authorities: the Registration Authority, the Financial Services Regulatory Authority, and the Abu Dhabi Global Market Courts. In collaboration with other international financial centres, global institutions and regulators, ADGM develops and supports member institutions with the regulatory framework, legal jurisdiction and attractive business environment they need for sustainable business growth (ADGM 2016).

4.12.1. Legal Infrastructure

Supporting Islamic Finance Laws

The legal system in the UAE, a federation of seven Emirates, is founded in its Constitution. Article 6 of the constitution stipulates that the “Shari’a is the main source of legislation.” The UAE legal system is founded upon the principles of the civil law doctrine which are heavily influenced by Egyptian law (Ali and Massey, 2013). However, having Sharia as the general guidelines for the laws in the UAE, principles of Islamic dealings both commercial and personal are embedded in some of the existing laws, such as the Civil Code (Federal Law No.5 of 1985) and the Commercial Transactions Law No.10 of 1982 (Ahmed, 2016; Ali and Massey 2013).

While several laws affect banking in UAE, the most relevant laws governing financial institutions and their operations include the following: Federal Law No. 10 of 1980 concerning the Central Bank, The Monetary System and Organization of Banking; Federal Law No. 6 of 1985 concerning Islamic Banks and Financial Institutions; Federal Law No. 5 of the 1985 concerning Civil Transactions; and Federal Law No. 18 of 1993 concerning Commercial Transactions. Other relevant laws are UAE Companies Law and Emirates Securities and Commodities Authority Laws (Khan and Walker, 2010, 585). All commercial banks

incorporated in the UAE must be established as public shareholding corporations under the UAE Companies Law and must be registered with the Federal Ministry of Economy and Trade. (Khan and Walker, 2010; Hashmi, 2007)

Article 1 of Federal Law No. 6 of 1985 concerning banks, financial institutions and investment companies defines Islamic banks, financial institutions and investment companies as “those companies whose Articles and Memorandum of Association include an obligation to apply the Islamic Sharia Law and that their operations would be conducted pursuant to Islamic Sharia Law”. Islamic banks and financial institutions (including licensed branches and offices of foreign Islamic banks and financial institutions and investment companies) are exempted by virtue of Article 4 of Law No. 6 of 1985 from some of the prohibitions imposed on conventional banks. These include carrying out commercial or industrial activities or acquiring, owning or trading in goods; acquiring immovable property for its own account; and having interest rates being paid by banks on deposits and the rate of interest and commission being collected from customers (Al Tamimi & Company 2016)

In the UAE, insurance is governed at a Federal level by the Insurance Authority (IA) established according to Federal Law No. 6 of the Year 2007 (the Insurance Law) which replaced the Federal Law No. 9 of the Year 1984 concerning Insurance Companies and Agents. The law applies to cooperative insurance, takaful insurance, reinsurance and insurance in general (Panchal, 2016). The IA has issued Board of Directors’ Decision Number (26) of 2014 Pertinent to Financial Regulations for Takaful Insurance Companies.

The Federal Law No. 4 of 2000 established the UAE Securities and Commodities Authorities (SCA) and empowers it to issue regulations, regulate the securities and commodities markets, receive reports and complaints relevant to the activities of the markets, and to impose penalties for non-compliance. SCA have issued Authority’s Board of Directors’ Decision No (16) of 2014 Concerning the Regulation of Sukuk that regulates issues related to the Sukuk market (SCA, 2014).

Tax regimes and impact on Islamic finance

There are barely any taxes related to financial institutions (FIs) in the UAE. In some limited areas of tax that banks and financial institutions may be subject to, there is no difference between conventional and Islamic FIs (Khan and Walker 2010). However, foreign commercial banks are subject to taxation at the national level. Normally they have to pay 20 per cent tax on their net income. (Khan and Walker 2010)

Dispute Settlement/Conflict Resolution Framework and Institutions

All of the Emirates, with the exception of Dubai and Ras al Khaimah that have retained their own courts, form part of the federal judicial system. UAE Federal Law No. 5 of 1985 concerning Civil Transactions (the ‘Civil Code’) together with Federal Law No. 18 of 1993 concerning Commercial Transaction Law (the ‘Commercial Code’) sets out the main provisions for civil and commercial transactions in the UAE (Ahmed, 2016). Accordingly, UAE courts apply the laws of the UAE in determining the case. The UAE courts are more likely to simply rely on the terms of the contract and are not obliged to take the Shari’a pronouncements of SSBs of Islamic financial institutions into consideration when determining a case (Ahmed, 2016).

There are no separate courts that adjudicate disputes arising out of Islamic financial transactions. Hence, federal or the local (Emirate) courts handle the disputes related to Islamic finance just like any other dispute and treat them as other cases and adjudicate them under the existing laws of the country. Since there is no fully-fledged Islamic banking law, and the Banking Law has only a very brief mention of Islamic banking, the courts utilize whatever relevant laws are available. Specifically, courts are likely to disregard Sharia elements in contracts and instead apply the applicable UAE law. However, the courts can refer to the Shari'a only when clear legislation and established customary business practices are absent (Ahmed, 2016).

The UAE Civil Procedure Code, Federal Law No. (11) of 1992 governs arbitration related issues under the following sections: Chapter (III) "Arbitration" - Articles 203 - 218; Chapter (IV) "Execution of Foreign judgments" - Articles 235 - 238; and Chapter (V) "Execution procedures" - Articles 239 - 243 (DIAC 2006). The major arbitration institutions administering arbitrations in the UAE are: Dubai International Arbitration Centre (DIAC), The Abu Dhabi Commercial Conciliation and Arbitration Centre (ADCCAC) and The International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA). There are other regional arbitration centres, in Sharjah and Ras Al-Khaimah, such as the Sharjah International Commercial Arbitration Centre and the Ras Al-Khaimah Centre of Reconciliation and Commercial Arbitration.

The DIAC was established by Dubai Chamber of Commerce and Industry in 1994 as the "Centre for Commercial Conciliation and Arbitration" (Ali and Massey, 2013). DIAC has become the busiest arbitration centre in the Gulf registering 413 new disputes in 2010 which leveled off to 390 cases in 2012 (Mohtashami, 2013, 1). However, no statistics could be found on the percentage of the cases that are related to Islamic banking and finance. The Dubai based IICRCA is dispute resolution forum specifically for the Islamic finance industry. It was established to resolve financial and commercial disputes arising between financial or commercial institutions or between such institutions and their clients or third parties through reconciliation or arbitration in accordance with the principles and rules of the Islamic Sharia (Ali and Massey, 2013, 7). While the IICRCA handles commercial disputes in the Islamic finance industry from across the GCC as well as Malaysia, there is no information on how many cases have been handled by it.

Bankruptcy and Resolution of Banks

There is no specific insolvency (bankruptcy) law in UAE and the government is planning to introduce it year. Article 306 of the Federal Law No. 2 of 2015 on Commercial Companies (Companies Law 2015) stipulates that companies can provide the methods of liquidation in their Memorandum of Association. In case this is not done, then Chapter 2 of the law provides the process of liquidation of a company. There is no separate framework of resolution of banks if they declare bankruptcy which includes Islamic financial institutions.

Currently, there are no sound bankruptcy and insolvency regimes to deal with sukuk instruments. Furthermore, the judiciary is, in its current state, not fully capable of dealing with defaults in sukuk that are international in nature and require cross border resolution.

4.12.2 Financial System Regulation and Supervision Framework

The regulatory framework for banking in the UAE is based on Federal Law No. 10 of 1980 that deals with, among others, central bank, the monetary system and the organisation of banking. The Central Bank under Federal Law No. 6 of 1985 gives regulatory powers to the central bank to regulate both conventional and Islamic banks, financial institutions and investment companies (Khan and Walker 2010; Hashmi, 2007). The establishment of UAE Central Bank was to bring about control and discipline to the banking sector in the country by regulating and supervising various financial institutions, including Islamic banks (Hashmi, 2007, 77-78; Khan and Walker, 2010).

While the licensing requirements for conventional and Islamic banks differ, the Central Bank regulates them in the same manner. Regulations/supervision is unified for both the Islamic and conventional financial sector and there is no separate regulatory/supervisory unit/department for the Islamic financial sector. Conventional banks may have Islamic windows subject to approval by the Central Bank. (CBUAE 2014: 66). The central bank has issued various general resolutions on various financial institutions such as banks, investment companies, brokers, finance companies, etc. that also apply to Islamic financial institutions (Al Tamimi & Company 2016).

The Central Bank is updating its regulatory framework in line with Basel III standards in the areas of capital, liquidity, risk management and corporate governance (CBUAE 2014). IFSB capital requirements standards are not applied to IFIs in the UAE. Islamic banks have come up with certain Sharia compliant instruments to meet the Basel III Tier 1 and Tier 2 capital requirements. These include Tier 1 Sukuk issued by Dubai Islamic Bank and Abu Dhabi Islamic Bank. Furthermore, these banks along with Al Hilal Bank also issue Tier 2 Sukuk. There are no special financial soundness indicators for Islamic banks.

The IA regulates both conventional insurance and Sharia-based insurance (Takaful) (Panchal, 2016). Resolution No. 4 of 2010 of IA deals with Takaful Insurance Regulations. The document provides regulatory guidelines of different types of takaful activities and their activities. Regulation of securities trading and transactions involving investment products was under the domain of the UAE Central Bank until 2000 when SCA was established. Under the law, the division of responsibility between the Central Bank and SCA is not clearly delineated. The Central bank recently entered into a memorandum of understanding with SCA pursuant to which certain regulatory authority of the Central Bank to regulate the offer and sale of foreign securities in the UAE was transferred from the Central bank to SCA (Khan and Walker, 2010, 584).

The SCA has generally limited its regulatory oversight to publicly listed UAE companies and four public securities exchanges in the UAE namely: Emirates Securities Markets (ESM), Dubai Financial Market (DFM), the Abu Dhabi Securities Exchange (ADX) and the Dubai Gold and Commodities Exchange (DGCX). On the other hand, the sale of foreign securities in the UAE is regulated by the Central Bank (Afridi and Angell, 2010). In 2014, the board of SCA approved regulations for sukuk and corporate bonds.³⁷

³⁷ <http://www.sca.gov.ae/English/news/Pages/26-04-2014.aspx>

4.12.3 Shariah Governance Framework

Article 6 of Article 1 of Federal Law No. 6 of 1985 stipulates that the Articles and Memorandum of Association of Islamic financial institutions must provide for the establishment of a Shariah committee of not less than three persons who will ensure the adherence by such companies to Shariah principles in their operations and contracts. There is no specific Shariah governance framework required by licensed Islamic banks, takaful or Islamic capital markets institutions. The law does not provide the terms of reference for the Shariah Supervisory Boards (SSBs) at the Islamic financial institution (IFIs) level and leaves it to IFIs to decide on by incorporating these in their respective articles of association.

As per Article 5 of the aforementioned Law, the appointment of the relevant Shariah committee within each of these companies is subject to the approval of a Higher Shariah Authority attached to the Ministry of Justice and Islamic Affairs (Al Tamimi & Company 2016), although the Higher Shariah Authority does not exist yet. However, it was indicated that the Central Bank intends to establish the Higher Shariah Authority in the near future (WAM, 2015).

IA Takaful Insurance Regulations (IA 2010) stipulate the formation of a Supreme Fatwa and Shariah Control Committee within the Insurance Authority (Article 17) and provides details of forming a Shariah Control Committee at takaful companies. Other than requiring takaful companies to have by-laws for the committee and also have a Shariah controller, the regulations cover issues related to the formation of the committee, conditions of committee membership, powers and authorities of the committee and the committee's annual report. There are Shariah Standards for Sukuk issued by the Dubai Financial Market (DFM) (DFM, 2013). On the other hand, there are Sukuk Regulatory Standards issued by SCA (SCA 2014).

The regulatory authorities do not require IFIs to use IFSB/AAOIFI Shariah governance guidelines. UAE does not require Islamic financial institutions to use AAOIFI Shariah standards.

4.12.4. Liquidity Infrastructure

In the aftermath of the global financial crisis, the Central Bank has taken some measures to address the liquidity issues in the UAE banking sector. Some specific initiatives include launching an AED 50 billion repo facility for banks and a subscription of USD10 billion in a government of Dubai bond issue (Khan and Walker, 2010, 588). However, there is no institutional liquidity management framework (i.e. markets and arrangements) for Islamic financial institutions *per se*. IFIs have taken initiatives themselves to come up with interbank money market arrangements. This non-regulated framework uses liquidity management instruments and products such as overnight commodity murabaha and Islamic repo.³⁸ Given the above, adequate Shariah compliant instruments that can meet the requirements of Liquidity Coverage Ratio (LCR) that fulfill the High Quality Liquid Assets (HQLA) do not exist.

There are no specific rules that govern LLOR facilities for Islamic financial institutions. However, *wakala* and *mudaraba*-based structures were developed due to the fact that the fiscal policy of the country required the Central Bank to provide support for all IFIs in 2009 when the global financial crisis occurred. In 2011, the Central Bank came up with a Collateralized

³⁸ The source of information is from interviews of market participants.

Murabahah Facility to provide a source of liquidity for Islamic banks (CBUAE 2011).

4.12.5. Information Infrastructure and Transparency

Accounting and Auditing Framework/Transparency and Disclosure

The laws/regulations of the UAE do not require IFIs to use AAOIFI's financial accounting/auditing standards. Instead, the IFRS accounting and auditing standards are used by IFIs. The UAE does not require Islamic financial institutions to adopt AAOIFI and IFSB standards on transparency and disclosure. As such, the laws and regulations of the country require disclosure of specific items that are relevant to IFIs such as information relevant to Profit-Sharing Investment Accounts (PSIA) holders and Shariah governance. Islamic banks are subject to the same reporting requirements as conventional banks. The regulator requires financial institutions to be transparent and disclose adequate information as per the IFRS standards. All banks are required to publish quarterly audited accounts and have their annual audited accounts approved by the Central bank before they are published (Khan and Walker, 2010, 585).

Articles 34 and 35 of Federal Law No. 4 of the Year 2000 require companies, whose securities have been listed in the market, to promptly furnish it with any information which affects the prices of the securities upon the same becoming available to them. Furthermore, the market's board of directors are granted the right to publish such information in the local press and other media it deems appropriate. Moreover, the aforementioned companies are required to publish, when so requested, any explanatory information which relates to their circumstances and activities and is such as to secure the integrity of transactions and the confidence of investors. There are standards for sukuk issued by SCA to improve transparency and identify information that will be disclosed in sukuk prospectuses (SCA 2014).

Rating Agencies

The Abu Dhabi Chamber of Commerce & Industry and Dubai Chamber of Commerce & Industry provide credit ratings and business information reports of some companies.³⁹ However, whereas there is no dedicated organization that provides credit ratings for securities and sukuk issuance, international rating agencies such as Moody's are used to issue ratings for sukuk that are marketed globally. These mechanisms, however, are usually market driven (i.e. the rating mechanism is not required by the regulator), as many bodies and investors will not be willing to invest except if the rating for the instrument is provided by a well-established credit rating agency. In UAE, there is no rating agency that provides Shariah rating of Islamic banks and sukuk structures.

³⁹ See <http://www.abudhabichamber.ae/English/Services/Pages/Credit-Rating-Services.aspx> and <http://www.dubaichamber.com/en/services/business-protection/credit-rating>

4.12.6. Consumer Protection Architecture

Consumer Protection and Financial Literacy

There are no dedicated laws/regulations to protect consumers of the financial sector in particular. The available consumer protection laws are very general and are mainly for the retail sector (not for the financial sector). There is no dedicated institutional mechanism/arrangement where consumers can address unfair treatment. However, those who are treated unfairly may resort to the Central Bank or any respective regulator that is governing the sector under which the unfair treatment has occurred. There is no dedicated Ombudsman office that deals with customer complaints related to Islamic finance; IFIs will have the same arrangement available for the conventional FIs – i.e. complaints are referred to the respective regulator of the subject sector.⁴⁰ The confidentiality of customer information by banks is not specifically provided for under the Banking Law, but the principle is recognized as a customary banking practice, and, implicitly, under certain regulations issued by the UAE Central bank. However, the Central bank has wide powers to obtain information (Khan and Walker, 2010).

IFSB standards on Governance and Conduct of Business Standards are currently not used by regulators. Prospectus disclosure on risk factors is more or less what is available in regards to the present guidelines that are meant to protect sukuk investors from risks faced (risk exposure to assets/obligor, liquidity risks, etc.). There are no specific schemes for financial literacy in the UAE in general. As such, there are no specific Islamic financial literacy schemes for consumers.

Deposit Insurance

While there is no formal deposit insurance scheme, the Central bank has guaranteed deposits with UAE banks and UAE branches of foreign banks since 2009 (Khan and Walker, 2010, 588). PSIA and conventional deposits are treated in the same manner under this scheme.⁴¹

4.12.7. Human Capital & Knowledge Development Framework

While there is the feeling that adequate personnel in the country to cater to the needs of the Islamic financial sector at different levels (such as regulatory bodies, IFIs, law firms, etc.) is lacking, the educational institutions and other public bodies supported by government that are contributing to enhancing the knowledge and skills for the Islamic financial sector are very limited. There are some universities and institutes such as Hamdan Bin Mohammed Smart University, Zayed University and Sharjah Islamic Center that are currently offering dedicated courses/certifications in Islamic banking and finance. The initiatives in the private sector to enhance the knowledge and skills for the Islamic financial sector are also limited. Ethica Institute for Islamic Finance is a fully-fledged institute that is dedicated to enhancing the knowledge and skills for the Islamic financial sector. Furthermore, on-job training conducted is conducted in the IFIs internally or through Sharia consultancy firms such as Dar Al Sharia, Minhaj Advisory and Al Ma'aali Consultancy.

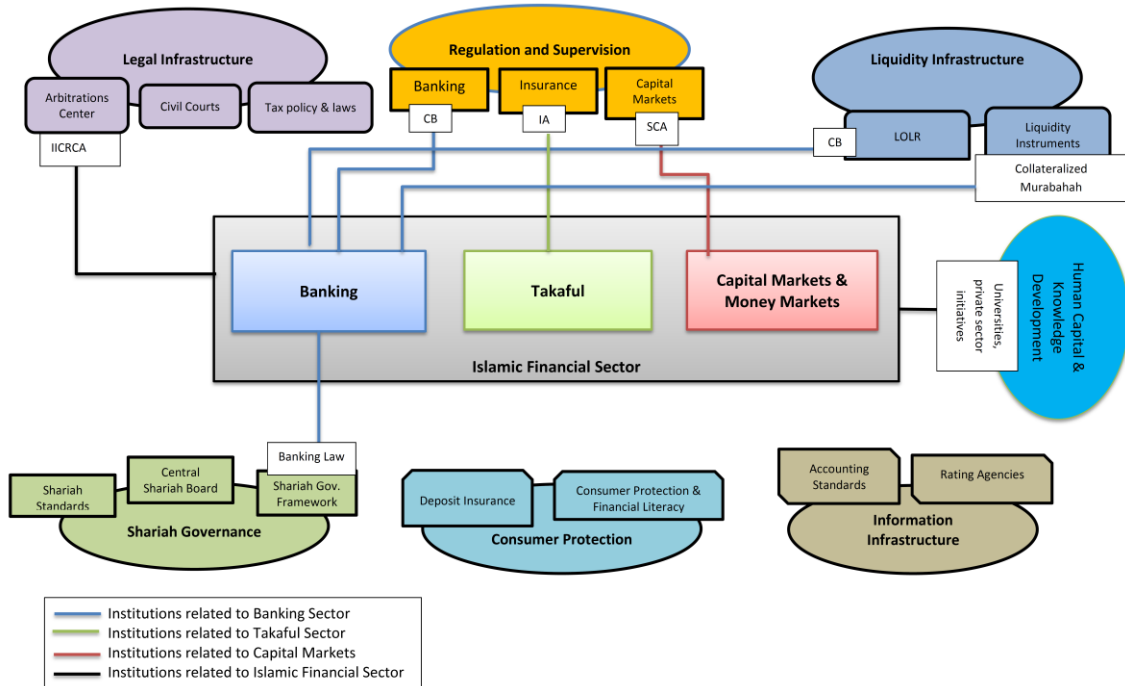
⁴⁰ The source of information is from interviews.

⁴¹ The source of information is from interviews.

4.12.8 Summary and Conclusions

Even though the UAE has one of the biggest Islamic financial industries, the infrastructure supporting the industry is relatively underdeveloped. While the financial laws recognize Islamic finance as a legitimate business, the regulators have come up with regulatory guidelines for different Islamic financial sectors. The banking law stipulates that Islamic banks should have Shariah boards but details of their governance are lacking. Though the banking law mentions a central Shariah board, by default it does not exist. There is one liquidity instrument that the central bank uses to manage the liquidity of Islamic banks and the central bank uses this instrument to provide funds to Islamic banks. There is no specific information infrastructure or consumer protection framework for Islamic finance. Some universities and the private sector have taken initiatives to provide education and training in Islamic finance in the country.

Chart 4.12: Islamic Financial Architecture Institutions—UAE



5. Global Financial Centres and Islamic Finance

This chapter examines the standing of Islamic finance in five global financial centres. It looks at their global status in conventional as well as Islamic markets, their strategic and practical approaches to Islamic finance, their legal and regulatory frameworks, their strengths and weaknesses in the context of Islamic finance, and lessons that can be drawn from them. It covers all three major sectors of financial services (banking, insurance and capital markets), though the significance of each of these varies from centre to centre.

The centres chosen are three European jurisdictions and two Asian ones: the United Kingdom (UK), which has global significance in all three sectors. Germany is also globally significant in all three sectors. Luxembourg is specialised in certain capital markets sectors and has done so on the basis of a very small domestic population. Singapore is significant in all three sectors with a limited domestic population and Hong Kong is significant in banking and capital markets, though less so in insurance, again with a limited domestic population.

The last three financial centres identified above are essentially city states. In the case of the UK, although London is the dominant financial centre, there is some business outside, particularly aimed at the domestic market. In the case of Germany, while Frankfurt is the principal centre for banking and capital markets, Munich is more important for insurance and there are some significant businesses, for example the large reinsurer Hannover Re, located elsewhere.

The three European centres are all members of the European Union (EU). Their financial services regulatory frameworks therefore must follow EU law, and there is thus very little difference between those frameworks, though there is a little more in their practical operations. In particular, for the banking sector, Germany and Luxembourg are both within the Single Supervisory Mechanism, which means that the practical operation, as well as the legal provisions of their regulation will be closely aligned.

5.1. Basic Data and Status of Financial Services

Table 5.1 sets out basic demographic and Gross Domestic Product (GDP) data for the countries concerned.

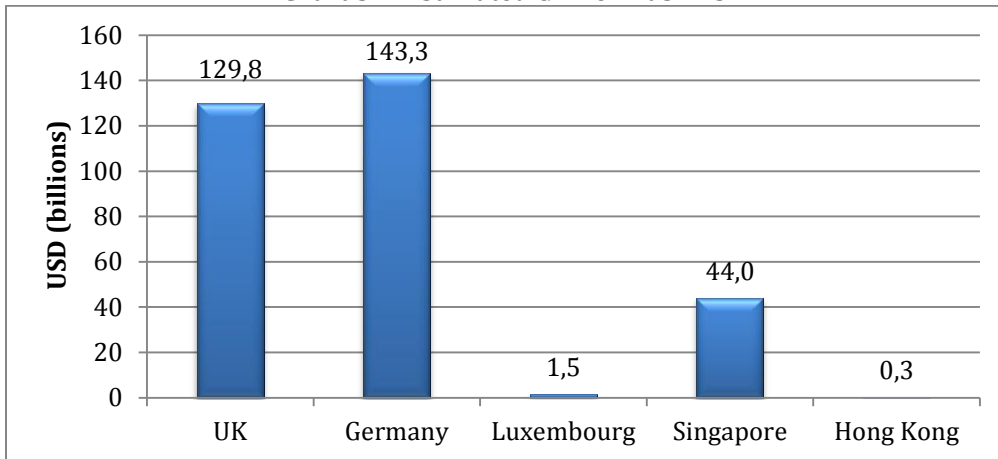
Table 5.1: Demographic and GDP Data

Country	Population (millions)	Muslims (%)	GDP (USD bn)
UK	64.1	4.4	2,950
Germany	80.9	3.7	3,874
Luxembourg	0.6	2.3*	66
Singapore	5.7	14.3	308
Hong Kong	7.1	0.1*	291

Source: Except where otherwise stated, all figures from CIA World Factbook; latest estimates as at January 2016. Figures marked * are from Pew Research Forum 2009.

As a crude indication of the income that might be available to Muslims in those countries, one can multiply the GDP by the percentage of the population that is Muslim. The estimated income of Muslim population in different countries is shown in Chart 5.1.

Chart 5.1: Estimated GDP of Muslims



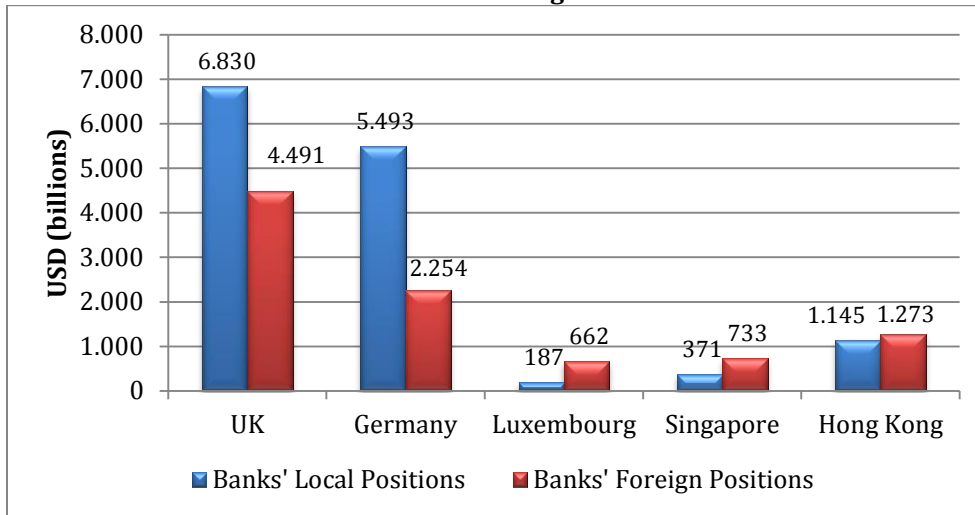
Assessing the size and importance of the financial services industry in each centre is not entirely straightforward. Comprehensive data is not available for all sectors, and is particularly sparse for non-banking, non-insurance activities (e.g. discretionary asset management). In addition, many data sets focus on where business is booked rather than where the principal activities are carried out. Thus, for example, Emirates NBD's funds, some of which are Islamic, are registered in Jersey, but the key research functions are carried out in the United Arab Emirates. Hence data based simply on the fund domicile does not necessarily capture where the economically valuable functions are located.

For some of the centres, foreign exchange and commodities trading are an important part of their business, as are derivatives of various kinds. Comprehensive data on these types of business are difficult to find. These are, in general, less relevant to Islamic finance than the sectors discussed, though of course some physical commodities may form the basis of commodity Murabaha transactions. They are therefore not discussed further.

The BIS Locational Banking Statistics gives asset data for banks located in each jurisdiction⁴². They show claims on the domestic sector and claims on the foreign sector separately. (This basis is helpful for present purposes because it is more relevant to the role of each as a financial centre than pure domestic data.) Banking claims for banks located in each of the jurisdictions of interest are shown in Chart 5.2.

⁴² The alternative BIS data set, the consolidated statistics, which cover banks headquartered in each country, unfortunately do not cover either Hong Kong or Luxembourg.

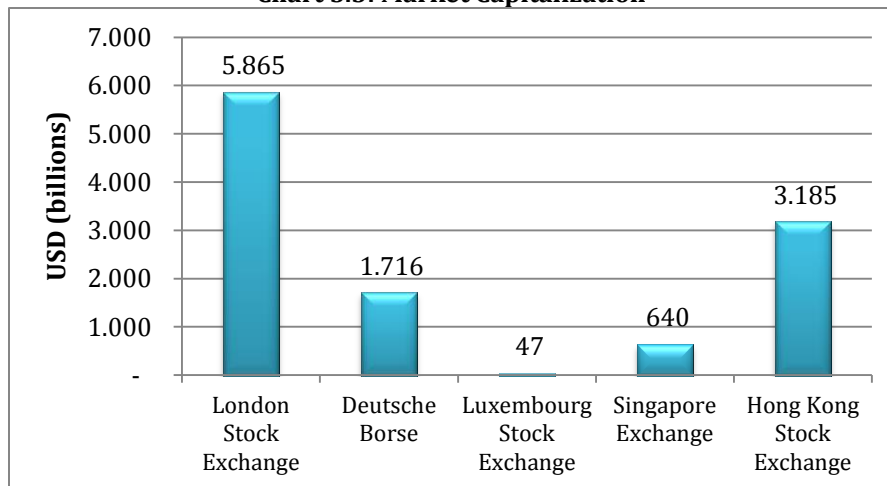
Chart 5.2: Banking Assets



Source: BIS Statistics Explorer, Q3 2015

For capital markets, the most useful data as a gauge of overall importance are from the World Federation of Exchanges monthly statistical reports. The figures for different exchanges for five countries are given in Chart 5.3.

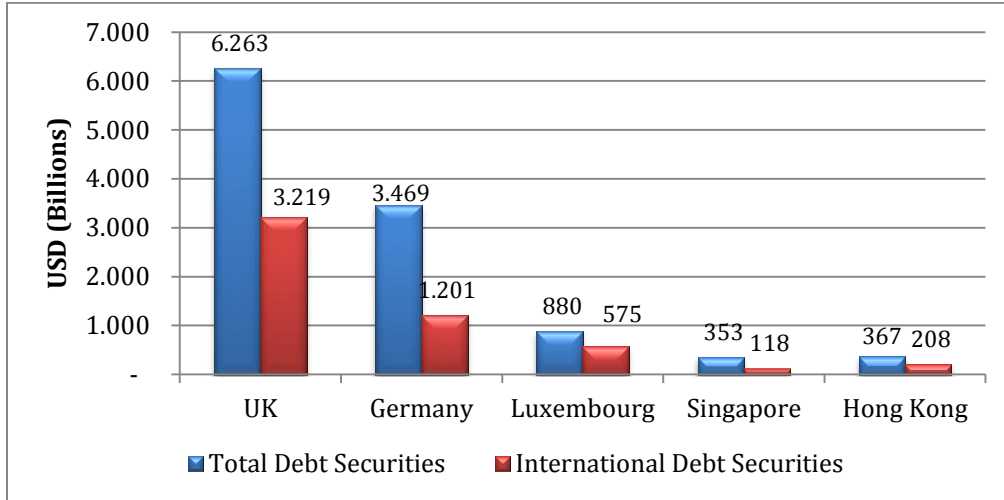
Chart 5.3: Market Capitalization



Source: Data from the World Federation of Exchanges monthly report, December 2015, except London Stock Exchange, for which figure is from the Exchange's own website. Figures as at 31 December 2015

In the context of sukuk, which are often classed with debt securities, it is also useful to look at the data on these. Chart 5.4 shows the figures for outstanding debt securities issued in the jurisdictions along with the international component.

Chart 5.4: Debt Securities Issued



Source: BIS Statistics Explorer, end Q2 2015

Many of the debt securities included in these figures will not be listed on any regulated market, so cannot be compared directly with the previous set of figures, but they are nevertheless significant as an indicator of each jurisdiction's importance in debt markets and of the balance between domestic and international business.

However, Luxembourg has established a special position as a funds domicile. The most useful comparative data in this area comes from the International Investment Funds Association Q3 2015. However, they cover regulated open-ended funds only, and so they are not absolutely comprehensive, but they give an indication at least of the significance of fund domiciles. They show the following values: UK USD1544 bn, Germany USD1794 bn, Luxembourg USD3526 bn. Unfortunately they do not cover Hong Kong and Singapore, but the Hong Kong Securities and Futures Commission on its website shows a value for regulated funds of USD1322 bn at the end of 2014. Statistics for Singapore are harder to come by, partly reflecting the fact that many funds on offer in that country are packaged as insurance products.

Table 5.2: Assets under management (AuM) in Europe

Countries	AuM (Euro bn)	AuM/GDP (%)
UK	6101	302
France	3258	154
Germany	1612	57
Italy	881	54
Netherlands	469	73
Belgium	229	58
Austria	85	26
Portugal	74	43
Hungary	25	25
Turkey	18	3
Greece	9	5
Rest of Europe	3694	107

Source: European Fund and Asset Management Association Annual Review, April 2015. Data as at end 2013. "Rest of Europe" excludes Bulgaria and Romania. Data for Austria cover investment fund assets only.

Looking at the broader category of asset management which would include, for example, the management of discretionary portfolios, global data is not readily available, but, within Europe, the European Fund and Asset Management Association gives some data for assets under management (AuM) across Europe. Table 5.2 shows the data for AuM as a percentage of GDP are interesting as an indication of the significance of the asset management sector in the economy.

Unfortunately, Luxembourg is not identified separately in the table but from the figures already quoted it must account for the lion's share of the "Rest of Europe" figure with the further implication that discretionary portfolios (which in the European totals account for slightly more than investment funds) are a relatively small part of the picture in Luxembourg and Germany but a very large one in London.

Insurance is a somewhat different business, because for historic regulatory reasons it is common for major international insurance groups to set up locally-domiciled subsidiaries as separate legal entities to undertake their primary insurance business in any jurisdiction. (So, for example, the Allianz Group is headquartered in Munich, but much of the group's business will be booked in its 70 or so operating subsidiaries around the world.) Reinsurance, however, is an international business, as to a lesser extent are certain types of large commercial risk. The USFIO (2014) quotes the following figures for reinsurance premiums written in 2013 by domicile of the ultimate parent; the dominance of Germany is particularly obvious.

Table 5.3: Reinsurance premiums 2013 by domicile of parent

Location	Percentage of Total (%)
UK ⁴³	8.6
Germany	27.3
Switzerland	15.6
Other European	10.2
Americas	15.6
Bermuda	11.3
Asia-Pacific	11.3
Other	0.3

Source: US Federal Insurance Office (2014)

Another approach to understanding the significance of the five centres as international financial centres is taken by the GFCI (2015), produced by Long Finance. The Index is based on both so-called "instrumental" factors and the opinions of financial services professionals. Partly as a result, it has some methodological problems which lead to volatility in the outcomes and indeed to some possibilities to "game" them⁴⁴. But it does provide a different perspective. The rankings of centres located in the relevant countries ranked among the top 50 centres internationally are shown in Table 5.4.

⁴³ This figure is in fact quoted as "London", but since there is no material reinsurer headquartered in the UK outside London, the two may be regarded as the same.

⁴⁴ It is, for example, hard to find objective reasons why Riyadh should fall from 14th place to 57th in 6 months, or why Osaka should rise from 31st to 20th over the same period.

Table 5.4: Ranking of Global Financial Centers

Global Financial Centres	Ranking
London	1
Frankfurt	14
Munich	40
Luxembourg	19
Singapore	4
Hong Kong	3

Source: GFCI (2015)

The only remaining centres in the relevant countries quoted in the report were Glasgow (70) and Edinburgh (71). The Index also assigns profiles to each centre, based on how well connected a centre is, how broad its services are and how specialised it is. London, Frankfurt, Singapore and Hong Kong are all placed in the “global leaders” category, having both breadth and depth⁴⁵ and being globally connected. Luxembourg is classed as a “global specialist”, lacking the breadth of these four, and Munich is classed as “transnational diversified”.

Putting these pieces of evidence together, the following picture emerges:

The UK is, by any measure and on any criteria, a major global financial centre, with international activity very much dominated by London. It is strong across the board, in banking, capital markets and insurance, and has a strong professional services sector⁴⁶. A number of major financial institutions are domiciled there, and it is the principal European base for others. Its stock exchange is the largest outside the USA by market capitalisation, and all sectors of business have strong global presences.

For **Germany**, Frankfurt and Munich taken together are also globally powerful but primarily in banking and insurance; the capital markets activity, though very substantial in itself, has a less international focus than in London. In the case of Germany, the international presence through local operations of German-headquartered companies is at least as significant as the international activity in that market.

Luxembourg has a large financial sector in relation to its size but a modest one overall. It has specialised in capital markets and, in particular, acts as a fund domicile, an activity in which it has a major global position.

Singapore and **Hong Kong** are both globally important centres with large financial sectors in relation to their size. Hong Kong has much the more significant exchange; Singapore is a somewhat more of a significant insurance centre and also the major currency trading centre of Asia. Both are extremely strong as regional centres for global businesses and, in the case of Hong Kong, for mainland Chinese companies seeking access to wider markets. Their financial sectors thus tend to be dominated by companies domiciled elsewhere.

5.2. Approaches to Islamic Finance

There are two different dimensions of an approach to Islamic finance which are relevant to this analysis.

⁴⁵ “Breadth” refers to the diversity of financial services sectors that flourish in a given sector; “depth” to the strength of the investment management, banking, insurance, professional services and government and regulatory sectors. See page 11 of GFCI (2015) for full definitions.

⁴⁶ The GFCI (2015) also quotes ratings on professional services, but for the top centres in this category only.

One is whether it is intended to facilitate access to financial services by a local Muslim population or whether it is intended to support a position in international financial markets. The former approach would be likely to focus primarily on banking and to some extent Takaful; the latter on capital markets, wealth management and perhaps Retakaful. It is of course possible to take both approaches simultaneously (as two of the five centres considered here have done). However, the very small Muslim populations of Luxembourg and Hong Kong make the former approach effectively non-viable in those territories.

The second is the degree of active strategic involvement by Government or quasi-governmental bodies. At one end of the spectrum, official bodies may adopt a strategy which might, for example, involve changing tax or regulatory provisions, training initiatives, active promotion of the jurisdiction, issue of sukuk to provide investment opportunities for Islamic firms, etc. At the other, official bodies may adopt a purely passive approach, leaving commercial firms to enter the market as and when they see opportunities (and with a more or less facilitative attitude by regulators to any proposals that come forward).

This chapter argues that the UK and Singapore have both had Government-driven strategies aimed at both the domestic and international markets; Luxembourg and Hong Kong have had Government-driven strategies aimed at particular segments of the international markets; and Germany has taken a mainly passive approach, though German firms have been highly active in some sectors.

Because of the differences between these centres in context, strategy and achievement, the remainder of this chapter offers a brief narrative summary of the approach and achievements of each centre, before summarising it under the headings used in other chapters. It then draws some comparisons between them.

5.2.1. Strategic Approach and Achievements: UK⁴⁷

The UK had an early involvement with Islamic finance and has energetically promoted London as a centre for it, with support at all levels from the Prime Minister down⁴⁸. While the strategy has focused largely on London's position as an international financial centre, it has included a strong component of financial inclusion aimed at making Islamic financial products available to the UK Muslim population. The Government itself has been involved in this, with proposals to introduce a Shari'ah-compliant equivalent to student loans (DBIS 2014) and published guidance on the public registration requirements when Islamic finance is used to purchase land⁴⁹.

Islamic finance reached the UK in the 1980s with the first commodity Murabaha transactions through the London Metal Exchange, a business in which the Exchange has retained a strong position. The first UK Islamic bank, Al Barakara International, was launched in 1982. During the 1980s a number of investment banks offered bespoke Shari'ah compliant products to their Middle Eastern clients, mostly in the areas of trade finance, leasing and project finance (UKTI 2014).

⁴⁷ The analyses for the European centres draw on di Mauro et. al (2013).

⁴⁸ See for example the Government promotional material at <https://www.gov.uk/government/publications/guide-to-islamic-finance-in-the-uk>, UKTI (2014) and material from the City of London promotional body at: <https://www.thecityuk.com/research/the-uk-leading-western-centre-for-islamic-finance> and UKTI (2015). Numerical data in this section comes largely from those publications.

⁴⁹ See: <https://www.gov.uk/government/publications/islamic-financing/practice-guide-69-islamic-financing>

The first significant political and regulatory support, however, came in 2000 when an Islamic finance working group was set up under the leadership of Andrew Buxton, former Chairman of Barclays Bank and Eddie George, then Governor of the Bank of England. Since the formation of this working group, the UK Government and regulators have attempted, through the addition of Alternative Finance clauses to various Taxation Acts, to create a market environment where Islamic banks and their clients are not treated any differently to their conventional counterparties. For example tax law was amended in order to remove capital gains tax and double stamp duty for sukuk issuances and Shari'ah-compliant mortgages, and tax arrangements for sukuk issuances also ensured that returns and income payments would be treated similarly to interest on conventional bonds (UKTI 2014).

In 2013, the Government launched the UK's first Islamic Finance Task Force. The Task Force supported the development of the UK's Islamic finance sector, helping to increase inward investment and strengthen the economy. It included senior industry practitioners to ensure that the UK's offer is promoted at home and abroad by both the public and private sector (UKTI 2014). In 2015, the Bank of England became a member of the Islamic Financial Services Board.

At the level of financial services regulation, the UK is, like Germany and Luxembourg, a member of the EU, and therefore very large parts of its financial services regulation are set at the European level. Following a period of scepticism about Islamic finance, the regulatory approach has become facilitative but within existing regulation. Thus, for example, profit sharing investment accounts of Islamic banks are treated as deposits for capital adequacy purposes and there are no provisions in UK law or regulation for Shari'ah governance in Islamic finance. This appears partly to reflect a perceived political difficulty in referring to Shari'ah in any UK legislation. So the legislation to facilitate sukuk refers to them as "alternative finance investment bonds"⁵⁰. More recently, the Bank of England has made it explicit that the UK's regulatory regime is a secular one and that "as the authorities are financial rather than religious regulators, the development of Shari'ah compliance standards in the UK must be market led" (Bank of England 2016).

The UK is nevertheless home to the West's first fully fledged Shari'ah-compliant retail bank (di Mauro et. al 2013) and currently has five fully Islamic banks with assets of USD2bn at end 2014. Another 15 banks offer some Islamic products, for example Islamic mortgages (TheCityUK 2015a). In addition, The European Islamic Investment Bank has its headquarters in London but despite its name is authorised as an investment firm rather than a bank. A significant part of these banks' business is aimed at overseas customers wishing to invest in Britain, and they have made substantial Shari'ah-compliant investments, particularly in real estate (TheCityUK 2015a). The Bank of England has continued to establish infrastructure for Islamic banking, and in particular for liquidity management. In addition to the UK's sovereign sukuk issue discussed below, it has now issued a consultation paper on establishing Shari'ah compliant facilities for deposits with the central bank and for the provision of liquidity by it (Bank of England 2016)

In June 2014, the government became the first western country to issue sovereign Sukuk (a few months ahead of Luxembourg). £200 million of Sukuk, maturing on 22 July 2019 were sold to investors based both in the UK and in the major hubs for Islamic finance around the world (TheCityUK 2015a). The concept of such an issuance had first been floated in 2007 but plans

⁵⁰ See, for example, Schedule 2 to the Taxation (International and Other Provisions) Act 2010, <http://www.legislation.gov.uk/ukpga/2010/8/schedule/2>, or the Alternative Finance Investment Bonds (Consequential Amendments) Instrument 2010, https://www.handbook.fca.org.uk/instrument/2010/2010_6.pdf.

were withdrawn in the aftermath of the crisis in 2008 (Reuters 2008). The avowed reasons for the 2014 issuance were largely to do with the UK's ambitions to be an international centre for Islamic finance. The relevant press statement said "Today's issuance of Britain's first sovereign Sukuk delivers on the government's commitment to become the western hub of Islamic finance and is part of our long term economic plan to make Britain the undisputed centre of the global financial system. ... By issuing sovereign Sukuk, the government has demonstrated that it is possible to create a successful British base for Islamic finance." (UK Treasury 2014). In late 2014, the UK Government announced that its export credit agency was planning to provide Shari'ah compliant support for British exporters. Shortly afterwards, the agency underwrote its first Islamic bond, providing cover for a USD913 million sukuk issued by Dubai's Emirates Airline to fund new aircraft (TheCityUK 2015).

London has become a major centre for Islamic capital markets, based largely on the commercial success of the London Stock Exchange (LSE) as an international exchange. The LSE is a key global venue for the issuance of sukuk. Since August 2015 a total of 57 sukuk have been listed on the LSE with a total value of USD51bn. It also has an active market in Exchange Traded Funds (ETFs) including 4 Sharia compliant ETFs based on Islamic indices. A total of seven Shari'ah-compliant ETFs are currently traded on the exchange. A UK-based Islamic bank launched the first Shari'ah compliant fixed income fund in March 2009 (TheCityUK 2015a).

Takaful has not established itself so easily. The British Islamic Insurance Company (trading under the name Salaam Halal) was established in 2008 to offer primarily personal lines including motor insurance, but this was closed to new business the next year having failed to gain traction (Dunkley 2009). However, in 2013 the Cobalt platform was launched in the London market, allowing a number of insurance firms to offer capacity through Takaful windows with common management. This is directed at large commercial business in the international market and appears to date to have been more successful. Its capacity comes from insurers and reinsurers based in several jurisdictions, including a Shari'ah compliant syndicate at Lloyd's (TheCityUK 2015a, Cobalt 2015).

The UK is a major global provider of the specialist legal expertise required for Islamic finance, with around 25 major law firms providing legal services in this area. This will be supported by the fact that the law of England and Wales is a common choice for international financial business, including many sukuk. Specialist services are also available for advice on tax, listings, transactions, regulations, compliance, management, operations and information technology systems (TheCityUK 2015).

In absolute numbers, the UK is the largest provider of Islamic finance courses and degrees in the world, with 68 educational institutions offering courses. In terms of the total number of published research papers, between 2011 and 2013, the UK (with 149 published research papers), came second only to Malaysia (421). Among professional bodies, courses in Islamic finance are offered by the Chartered Institute for Securities and Investment (CISI), Chartered Institute of Management Accountants, Association of International Accountants and the Institute of Islamic Banking and Insurance. The Islamic Finance Council UK has developed a Scholar Professional Development Programme in conjunction with CISI to teach conventional finance to Sharia scholars worldwide. Partners for this programme include the Central Bank of Bahrain and the International Sharia Research Academy for Islamic Finance (TheCityUK 2015).

The architectural institutions related to Islamic finance in UK are summarized below:

Legal infrastructure

Amendments to the legal infrastructure have been limited and have been aimed at securing neutrality, especially tax neutrality, between Islamic finance and its conventional counterpart. The Government has also made some of its own services, notably student loans, available in Shari'ah-compliant forms.

Financial System Regulation and Supervision Framework

No material changes have been made to the financial system regulatory framework which is, in any event, largely determined at the European level. Some unintended legal anomalies have been removed but the system continues to treat profit-sharing investment accounts as deposits, regulates Takaful in the same way as conventional insurance, etc.

Shariah Governance Framework

There is no provision for Shari'ah governance either at the national or firm level.

Liquidity Infrastructure

In this area the UK has been active. It has issued sukuk, and it has taken a facilitative approach to the admissibility of other sukuk for Islamic bank liquidity purposes (PRA 2015). It has also consulted on the development of Shari'ah-compliant central bank liquidity management facilities.

Information Infrastructure and Transparency

The UK uses IFRS and has made no amendments to accommodate Islamic finance.

Credit ratings in the UK are dominated by the major international agencies. While some of these have rating methodologies for Islamic institutions, there have been no UK-specific developments.

Consumer Protection Architecture

The UK has an advanced consumer protection and financial literacy architecture, but there are no developments specific to Islamic finance to record.

As noted above, profit-sharing investment accounts are treated as deposits for regulatory purposes, and are therefore eligible for cover from the UK's deposit insurer, the Financial Services Compensation Scheme. This also covers other financial services sectors so, for example, Takaful policyholders would be treated similarly to conventional insurance policyholders in the event of the undertaking's failure.

Human Capital and Knowledge Development Framework

As described above, the UK's professional and academic institutions are highly active in Islamic finance, primarily at their own initiatives, though with some government encouragement.

5.2.2. Strategic Approach and Achievements: Germany

Germany is in principle a country that should be in a strong position to develop Islamic finance. In addition to the positions of its cities as global financial centres, Germany is the largest economy in the EU and it has the largest Muslim population. It also has a strong external trade activity, including strong historical trade links with Turkey. However, it has chosen not to take an active strategic approach to the sector. The federal financial services regulator (BaFin) has

organised two conferences on Islamic finance, in 2009 and 2012 but these were largely for the purpose of advancing its own understanding (BaFin 2009 and 2012).

Following the first of these conferences, an article in BaFin's quarterly bulletin for Q4 2009 quoted the then President of BaFin as saying that BaFin "wanted to lay the regulatory and supervisory groundwork for Shari'ah-compliant products within the scope created by legislation. Basically there were no obstacles under supervisory law preventing the establishment and licensing of an Islamic bank" (BaFin 2009). This was, in context, a statement that Islamic banking at least could be accommodated within existing law. The account of the second conference given in the bulletin for Q2 2012 was even less forthcoming and treated the conference as essentially a fact-finding exercise (BaFin 2012). Germany has thus not pursued an active strategic approach to Islamic finance and has not adapted its laws or regulations to accommodate it.

Nevertheless, in 2009, BaFin accepted a request from a foreign institution, Kuveyt Turk, to conduct banking operations within the country in accordance with Islamic principles. (ECB 2013) The operation was set up in Mannheim in 2010 but without a full banking licence. The range of offerings therefore remained limited. The firm applied for a full banking licence in 2012 and this was finally granted in 2015. KT Bank AG therefore opened its first branch, in Frankfurt, in mid-2015 and has expressed ambitions to expand into Eastern Europe.

In capital markets, Germany was the first Western country to tap the Islamic capital market when the federal state of Saxony-Anhalt issued the country's first *sukuk* in 2004. The paper attracted strong demand and was fully subscribed, with 60% of the issue going to investors in Bahrain and the UAE and the remaining 40% to investors in Europe, particularly those in France and Germany. The €100 million Ijarah *sukuk* was fully redeemed in 2009. (ECB 2013) However, the *sukuk* were issued and listed in Luxembourg and this initiative can be seen as an attempt to tap a new market by one of the financially weaker German states rather than as a strategic initiative. This has not been followed up. The German insurance firm FWU has, however, issued two modest *sukuk* tranches, but again in Luxembourg where it has a long-standing operation (Reuters 2013). On the other hand, although it does not publish relevant statistics, Frankfurt has been a popular exchange on which to list international *sukuk* (which commonly have multiple listings.)

There are a few Islamic collective investment schemes (CIS) offered in Germany, but few if any domiciled there. Similarly, there appears to be no Takaful offering there.

On the other hand, German financial institutions are prominent in the Islamic finance industry via their operations outside Germany. Deutsche Bank has been an active participant, though in structuring and support services rather than in offering banking products. However, its core Islamic finance structuring team is based in Dubai and Doha with resources in London and Kuala Lumpur.⁵¹

In insurance/Takaful, Munich Re is the world's largest reinsurer and has a significant Retakaful operation, but this is based in Kuala Lumpur (Munich Re 2012). Hannover Re is also an important reinsurer with a Retakaful operation based in Bahrain.⁵² Allianz, Europe's largest insurer, based in Munich, had a Takaful operation based in Bahrain, but in 2011 transferred a majority share to the local operator MedGulf.⁵³ Its life operation in Indonesia continues to offer

⁵¹ Source Deutsche Bank website: https://www.db.com/mea/en/content/islamic_finance.htm.

⁵² <http://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapid=30598160>.

⁵³ <http://www.medgulftakaful.com/bh/pressmed.html>.

Shari'ah-compliant policies, however. Finally, FWU, which has already been mentioned, is a medium-sized company based in Munich and is largely concerned with creating insurance products, some of them in the Takaful area. Its centre of excellence for Takaful is in Dubai.⁵⁴

German universities have had research activities in Islamic finance, and Masters' courses in that area are currently offered in Bremen, in a joint programme with a Malaysian institution.⁵⁵

Overall, therefore, Germany has adopted a facilitative rather than a strategic approach to Islamic finance, and very little Islamic business has so far been done in that country. Germany's presence in international markets has been seen mainly in banking and Takaful, but through the operations of German companies in other jurisdictions.

The architectural institutions related to Islamic finance in Germany are summarized below:

Legal infrastructure

Germany has made no adjustments to its legal system to accommodate Islamic finance. In particular, it has not yet provided tax neutrality for sukuk.

Financial System Regulation and Supervision Framework

No material changes have been made to the financial system regulatory framework which is, in any event, largely determined at the European level. The system treats profit-sharing investment accounts as deposits and this would regulate Takaful in the same way as conventional insurance, etc.

Shariah Governance Framework

There is no provision for Shari'ah governance either at the national or at firm level.

Liquidity Infrastructure

There appears to have been no moves to assist Islamic banks in managing their liquidity.

Information Infrastructure and Transparency

Germany uses IFRS and has made no amendments to accommodate Islamic finance.

Credit ratings in Germany are dominated by major international agencies and the local agency Euler Hermes. While some of the international agencies have rating methodologies for Islamic institutions, there have been no developments specific to Germany.

Consumer Protection Architecture

Germany has an advanced consumer protection and financial literacy architecture, but there are no developments specific to Islamic finance to record.

Profit-sharing investment accounts are treated as deposits for regulatory purposes and are therefore eligible for cover from the German deposit insurance schemes, (There are several of these, covering different segments of the industry, but collectively meeting the requirements of European law.)

⁵⁴ <http://www.fwugroup.com/cms/en/fwu-group/fwu-global-takaful-solutions.html>.

⁵⁵ https://www.daad.org/file_depot/0-1000000/10000-20000/16426/folder/102046/HS+Bremen+Graduate+Study+Presentation.pdf.

Human Capital and Knowledge Development Framework

There is some research and postgraduate training provided by German academic institutions.

5.2.3. Strategic Approach and Achievements: Luxembourg

Luxembourg's position as one of the major financial markets in Europe is dominated by its position in capital markets, and based on competitive pricing, incentives, speed of response and access to European clients (ECB 2013). It is particularly strong in CIS, and is the second largest investment fund centre in the world for regulated funds, after the US (Lff 2014). It became the first EU jurisdiction to adopt the UCITS IV funds directive at the end of December 2010, and, already being a major domicile for both conventional and Islamic investment funds, it had a first-mover advantage (ECB 2013). It is being promoted strongly by its government to attract more Islamic business⁵⁶ as well as foreign investments from oil-rich countries and emerging wealthy nations.

In 2008, the Luxembourg government set up a cross-sector task force charged with identifying obstacles to the development of Islamic finance in Luxembourg and ways to support its growth (Lff 2014). Subsequently, Luxembourg for Finance, the agency for the development of the financial centre and the Association of the Luxembourg Fund Industry (ALFI) established working groups, including a regional working group in Dubai, focusing inter alia on Islamic finance matters. A key finding of the working groups was that Islamic finance would not require additional legislation. (Stainier and Shibliq 2014) In 2009, the government announced its programme for the diversification of the financial centre: it identified Islamic finance as a key area for development, alongside microfinance and socially responsible investment. In the same year, the Central Bank of Luxembourg became the first EU Central Bank to become a member of the Islamic Financial Services Board (IFSB), and it hosted the IFSB's annual Summit in 2011.

In 2002, Luxembourg became the first European country to list a sukuk. In 2004, it passed a Securitisation Law (amended in 2014) which provided for a range of securitisation vehicles though this was not aimed exclusively at the sukuk market. Since then, several sukuk structures have been implemented in Luxembourg and 20 sukuk have been listed on the exchange (of which 19 were still listed at April 2015). Deutsche Bank has a sukuk issuance platform based there (as at one time did another firm, Dar Al-Istithmar) (ECB 2013). Luxembourg itself issued the first sovereign sukuk to be denominated in Euros, in 2014.

Luxembourg has the highest number of *Shari'ah*-compliant investment funds after Saudi Arabia and Malaysia. By assets under management, it also ranks behind Jersey and the USA, reflecting the relatively small average size of its funds. At the end of 2014, it had USD2.3 billion Islamic AuM,⁵⁷ largely in equity funds domiciled in Luxembourg and managed and promoted by global investment companies. A favourable legal framework combined with the UCITS qualification allows Islamic funds domiciled in Luxembourg to be a successful instrument for Gulf investors wishing to tap the European market (Thomson Reuters 2015).

⁵⁶ See, for example: <http://www.luxembourgforfinance.com/financial-centre/products-services/islamic-finance> and the brochure referenced there (Lff 2014). The Luxembourg Stock Exchange, with PwC, has also published a brochure on listing sukuk.

⁵⁷ Figure from Thomson Reuters (2015). The higher figure claimed in Luxembourg's own brochure comes from the Thomson Reuters-Lipper 2014 report. The differences in the figures between the two reports, which are not confined to Luxembourg, suggest there may be issues of data quality and consistency.

Luxembourg's institute for training in banking (Institut de formation bancaire Luxembourg) offers both a foundation certificate and an advanced diploma in Islamic finance, and the Luxembourg financial services supervisor (Commission de Surveillance du Secteur Financier, CSSF) has signed a number of co-operation agreements with its counterparts in jurisdictions with a strong Islamic finance interest.

There are currently no Takaful products offered in Luxembourg, though FWU, which has been discussed in the context of Germany, has a long-standing operation there.

As already mentioned, Luxembourg operates within a financial services regulatory framework set dominantly at the European level. As Luxembourg's own brochure says, referring to Islamic funds, "The CSSF does not place any conditions on a fund with regard to the compatibility of its investments with Shariah law. From a regulatory perspective, the CSSF will seek to ensure that all applicable Luxembourg legal requirements are complied with, that the persons involved in the management of a fund have adequate expertise and that the sales documentation is sufficiently clear to allow investors to understand the consequences of their investment." (LFF 2014) In other words – and private sources have confirmed that the same is true of sukuk – the Luxembourg approach is to make no special provisions for Islamic finance within its financial services regulation, but to apply the frameworks flexibly, particularly in respect of disclosure, to ensure that the disclosures that would be required by a religiously-sensitive investor are made.

The architectural institutions related to Islamic finance in Luxembourg are summarized below:

Legal infrastructure

Luxembourg has published tax guidelines which establish tax neutrality for Islamic finance vehicles, notably sukuk, in relation to conventional counterparts. Otherwise there have been no amendments to the legal infrastructure.

Financial System Regulation and Supervision Framework

No changes have been made to the financial system regulatory framework which is, in any event, largely determined at European level. Luxembourg does, however, make a point of applying it flexibly, using general provisions to require disclosures about such things as Shari'ah governance.

Shariah Governance Framework

Luxembourg does not have any national Shari'ah governance arrangements nor mandate any form of governance in forms.

Liquidity Infrastructure

There is currently no Islamic bank in Luxembourg, and this issue has therefore not arisen.

Information Infrastructure and Transparency

Luxembourg uses IFRS, and has made no amendments to accommodate Islamic finance.

There is no credit rating agency based in Luxembourg, though the major international agencies are active. While some of these have rating methodologies for Islamic institutions, there have been no Luxembourg-specific developments.

Consumer Protection Architecture

Given Luxembourg's minimal Muslim population there have, unsurprisingly, been no developments specific to Islamic finance.

There is currently no Islamic bank in Luxembourg, and this issue has therefore not arisen.

Human Capital and Knowledge Development Framework

As described above, there is currently some training provided by professional institutions.

5.2.4. Strategic Approach and Achievements: Singapore

Singapore has been attempting to position itself as a major Islamic finance jurisdiction since 2005, building on its strong and diversified position as an Asian financial centre, but it has also sought to provide Islamic financial services to its significant Muslim minority.

An early, and particularly helpful, statement of Singapore's strategic approach was given in a speech by the Deputy Managing Director of the Monetary Authority of Singapore (MAS), Mr Ong in remarks to a conference in March 2005 in which he stated that Singapore cannot be a complete international financial centre without offer Islamic financial services (Ong 2005). He went on, however, to say that this was not the same as expecting Singapore to be an Islamic banking hub. With a small domestic market, the larger opportunity would be to leverage off Singapore's existing infrastructure and to offer wholesale market activities in the areas of wealth management and capital markets. To this end, an active strategy was initiated by MAS for the market's future development and some specific initiatives were set out including a higher level of participation in the work of the IFSB whose annual Summit was hosted in 2009.

As regards banking, no fundamental change to the banking regulations was envisaged other than fine-tuning the rules to accommodate and facilitate the development of Islamic finance (Ong 2005) This has indeed been the policy that has been followed subsequently by MAS, with no materially different regime from that applied to conventional banks but with some helpful published interpretations (MAS 2010) and minor amendments where necessary (for example to facilitate banks in Singapore offering financing based on the Murabahah concept by exempting the relevant purchasing and selling of physical goods from the restrictions on banks conducting non-financial activities, and, later, through an amendment to make it possible for banks to fund projects using Istisna'a) (MAS 2009-2010). Singapore's interpretations include treating profit-sharing investment accounts as risk-bearing investments rather than deposits.

As regards tax, the overall policy approach was to align the tax treatment of Islamic contracts with the treatment of their conventional counterparts (Ong 2005) . In line with this policy, the Finance Ministry announced several changes in the 2005 and 2006 budgets. In 2005, Singapore waived the imposition of double stamp duties in Islamic transactions involving real estate and accorded the same concessionary tax treatment on income from Islamic bonds as that applicable to conventional bonds. In 2006, income tax and goods and services tax applications on some Islamic products, most importantly sukuk, were further clarified, again with the aim of aligning the tax treatment with that of conventional bonds.

In 2001, Maybank, Malaysia's largest bank, began marketing an Islamic collective investment scheme in Singapore. In 2005, it moved into Islamic banking proper by introducing a Shariah-complaint online savings account and Shariah-compliant savings cum checking account. (Duriat 2015) In 2006, the first Shariah-compliant term deposit in Singapore was launched by OCBC Bank. The most important development in the banking sector was, however, the launch in 2007 of the Islamic Bank of Asia, a joint venture between Singapore's largest bank, DBS, and

a group of GCC investors, with USD500 mn of paid-up capital (MAS 2011 and DBS 2007). In September 2015, however, DBS announced the decision to close this unit since it was “unable to achieve economies of scale” (DBS 2015). However, Islamic banking products remain on offer in Singapore, primarily through Islamic windows operated by Malaysian banks⁵⁸.

Wealth management is another area that fund managers based in Singapore seizing opportunities to manage funds Islamically. Benefiting from the structuring and fund management expertise, conventional fund managers are working in partnership with Islamic financial institutions and Shariah scholars to develop suitable Shariah compliant products and funds (Ong 2005). While there are possibilities of developing of Islamic hedge funds (an industry which, in the event, has not taken off, largely for Shari’ah reasons) and Islamic REITs, no specific steps have been taken. At end of 2014, Singapore had only 5 funds domiciled there, with an AuM of USD 0.66 bn (Thomson Reuters 2015). Nevertheless, Singapore claims the world’s largest listed REIT and other real estate funds have launched there, some of them with a limited time frame. An Islamic ETF was launched in May 2008.

Similarly, in the area of capital markets, given the large investor community in Singapore the financial centre was host to various Islamic bond roadshows (Ong 2005). In fact, Singapore has become an important centre for sukuk issuance and listings. In 2009, the government announced that it had established a facility to issue sukuk (with the provision of regulatory assets to Islamic banks as a significant motivation), and in that year Singapore became the first non-Muslim majority country to issue a sovereign sukuk. On a smaller scale, there has been some innovative use of musharakah sukuk by the body which administers a number of charitable foundations (awqaf) to fund their development (Goh 2007). By June 2015, 31 sukuk had been issued in Singapore, and the value outstanding in 2014 reached USD3.8 bn (Loh 2015). However, there was only one, relatively small, issuance in 2015.

As regards Takaful, both Takaful and Retakaful were already available in Singapore and saw the possibility of Singapore’s becoming a regional base for that activity and for the associated fund management (ong 2005). To encourage the underwriting of offshore takaful and retakaful products and services from Singapore, a concessionary 5% tax was introduced with effect from FY 2008 (Tai 2010). This had an initial 5-year duration and was allowed to lapse in 2013 [Ng 2013]. Although Takaful products were launched by a number of providers, there appear, from the MAS website, to be no Takaful companies currently authorised in Singapore, though some Takaful products remain available (e.g. through banks). In 2004, Singapore licensed its first rated retakaful company, Tokio Marine Retakaful (Tai 2010), but this also has now left the business, though as part of a more general reorganisation of its reinsurance activities.

Singapore has undertaken a number of educational initiatives. These have, however, come from educational and training providers in association with industry players, though MAS has been supportive of such efforts⁵⁹. The Singapore Islamic Scholars and Religious Teachers announced in September 2006 that, in order to develop *Asatizah* (religious teachers), it would introduce a Shariah Advisers Training Programme organized jointly with the Kuala Lumpur-based International Institute of Islamic Finance (Khan and Bashar 2008). The Singapore Management University (SMU) operates International Islamic Law and Finance Initiative, and seeks to carry out research and develop thought leadership in Islamic law and finance, in

⁵⁸ There are unfortunately no statistics available on either Islamic banking or Takaful in Singapore (Monetary Authority of Singapore, private communication).

⁵⁹ Monetary Authority of Singapore, private communication

collaboration with institutions in UK, Malaysia and Indonesia. SMU also teaches Islamic finance as a specialization in its Master of Laws courses. In addition, Islamic finance has been included as an eligible subject area under MAS' Finance Scholarship Programme (Loh 2015).

The architectural institutions related to Islamic finance in Singapore are summarized below:

Legal infrastructure

Amendments have been made to the tax legislation to establish tax neutrality between Islamic financial products and their conventional counterparts.

Financial System Regulation and Supervision Framework

As indicated above, Singapore has made only minor amendments to its regulatory regime to accommodate Islamic finance, but has adopted helpful steps. These include treating profit-sharing investment accounts as risk-bearing investments rather than deposits.

Shariah Governance Framework

Singapore does not have a central Shari'ah body or mandate any particular form of Shari'ah governance.

Liquidity Infrastructure

Singapore has issued sovereign sukuk and, like the UK, has taken a facilitative approach to the admissibility of other sukuk for Islamic bank liquidity purposes (MAS 2015). It has not, however, gone beyond this.

Information Infrastructure and Transparency

Singapore is converging its standards with IFRS. It has made no amendments to accommodate Islamic finance.

Credit ratings in Singapore are dominated by the major international agencies. There are no Singapore-specific developments relevant to Islamic finance.

Consumer Protection Architecture

There appear to be no developments specific to Islamic finance related to consumer protection and financial literacy.

Deposit insurance is provided (on a conventional basis) by the Singapore Deposit Insurance Corporation. It covers deposits placed with Islamic banks (including explicitly those placed under Murabaha), but would not cover investment accounts. Its operation does not claim to be Shari'ah compliant.

Human Capital and Knowledge Development Framework

As discussed above, there is some activity in the academic sector and also a programme for Islamic scholar development.

5.2.5. Strategic Approach and Achievements: Hong Kong

Hong Kong's approach to Islamic finance has been capital markets focused, more or less from necessity, given its lack of a Muslim population.

A presence in the market was set out as a government priority in the Chief Executive of the Hong Kong Special Administrative Region's Policy Address for 2007-08 in which he identified the huge potential of development of Islamic finance and reiterated to actively leverage on

developing an Islamic financial platform to further consolidate Hong Kong's position as a global financial centre (HKSAR 2007: 14). Other than promoting Hong Kong's financial services to major Islamic countries and regions, the focus will be on developing an Islamic bond market. To accomplish these goals, Hong Kong Monetary Authority set up a dedicated team with the financial sector to study relevant issues and make recommendations for introducing Islamic debt offerings in Hong Kong (HKSAR 2007).

This has remained the strategy, with a focus specifically on attracting petrodollars for projects in China. Recognizing the huge financing needs to sustain the high growth of the Asian economies in general and China in particular, the regulators were aware that Hong Kong was well-positioned to play the unique role as a gateway to China by providing an effective platform. On the one hand the platform would enable Islamic investors to access investment opportunities in Asia, particularly China and on the other hand allow institutions raising funds to tap into the surplus funds and liquidity pool of the Islamic world (Pang 2014).

However, the tax changes necessary to provide neutral treatment as between sukuk and conventional bonds have taken time to be put in place and were passed only in 2013. (Pang 2014) Subsequently the Hong Kong government made a sovereign sukuk issuance in September 2014 and a second one in May 2015, each for USD1 bn. Both were listed in Hong Kong, Kuala Lumpur and Dubai. These were effectively demonstrations of Hong Kong's intent, and of its legal framework. The successful issuances showed the confidence among international investors of Hong Kong's economic fundamentals and financial structure and also the viability of sukuk issuance using Hong Kong's platform (HKMA 2015).

As yet, however, there have been no other sukuk issuances through Hong Kong, though a few Malaysian issues have been cross-listed on the Hong Kong Stock Exchange. Only one Chinese firm has so far issued a sukuk, and that was in Malaysia, to finance projects in that country (Chiang 2015).⁶⁰ One Hong Kong-based but Singapore-listed firm has also issued sukuk in Malaysia. (Moody's 2012).

As regards other aspects of Islamic capital markets, the first Islamic fund in Hong Kong was launched in 2014 but is domiciled in Malaysia (Y-Sing, Liau 2015 and RHB 2016). Hong Kong does not, as yet, have a significant presence in this market. There has been some interest in specialised fund types, notably the Real Estate Investment Trusts, but nothing has yet come to fruition.

As regards other sectors, an article in the Hong Kong Monetary Authority's Bulletin in December 2008 set out Hong Kong's regulatory approach to Shariah issues in banking. While emphasizing that HKMA is a secular regulator and does not review Shariah issues such as the role or composition of the Shariah supervisory board or the validity of Shariah edicts, it suggested that the Shariah compliance would be the responsibility of the banks. Among others, the banks are made responsible to ensure Shariah compliance of all Islamic financial products through a review process by the Shariah supervisory board before launching and carry out effective monitoring and Shariah audit after the product is launched. Furthermore, HKMA stipulates relevant information on Shariah compliance should be communicated to the customers (HKMA 2008). The article also discussed more technical issues, such as the treatment of sukuk for capital adequacy purposes. However, there is as yet no Islamic banking operation established in Hong Kong, nor any Takaful operation.

⁶⁰ Also see <http://www.4-traders.com/COUNTRY-GARDEN-HOLDINGS-C-1412616/news/Country-Garden-Issues-Sukuk-in-Malaysia-21621148/>

The architectural institutions related to Islamic finance in Hong Kong are summarized below:

Legal infrastructure

Hong Kong has provided for tax neutrality for sukuk, but has made no other changes to its legal framework.

Financial System Regulation and Supervision Framework

Hong Kong has made no changes to its financial system regulation, though it has issued some relevant guidance.

Shariah Governance Framework

No specific steps have been taken for Shariah governance either at the national or firm levels.

Liquidity Infrastructure

Hong Kong has issued sovereign sukuk, but, since it has no Islamic banks, the issues of liquidity are largely irrelevant.

Information Infrastructure and Transparency

Hong Kong reporting standards have been fully converged with IFRS. It has made no amendments to accommodate Islamic finance.

Both international and Chinese ratings agencies are active in Hong Kong. There are no Hong Kong-specific developments relevant to Islamic finance.

Consumer Protection Architecture

There appear to be no developments specific to Islamic finance in the areas of consumer protection and financial literacy.

Deposit Insurance is provided by the Hong Kong Deposit Protection Board. It has no provisions specific to Islamic finance, and since there are no Islamic banks in Hong Kong, issues of interpretation have not arisen.

Human Capital and Knowledge Development Framework

There are no significant developments relevant to Islamic finance.

5.3. Comparison and Analysis

The five centres studied display different patterns, both strategically and in terms of their success in Islamic finance.

In strategic terms, what all five have in common is that they have, at various speeds, made the necessary adaptations to their tax systems to bring Islamic instruments onto a level playing field with their conventional counterparts. None have followed the Malaysian approach of offering positive incentives for Islamic instruments or firms. Also, and more interestingly, none have materially changed their financial services regulation, although Singapore has made some minor adjustments, again with the broad aim of parity of treatment. However, the UK made one to clarify the treatment of sukuk and prevent some of them being treated as collective investment schemes (FSMA 2010). The jurisdictions have, in general, been prepared to interpret their regulations sympathetically but, for example, they have not, with the exception of Singapore, adjusted their capital adequacy regimes to take account of the way Islamic banks derive funds. Nor, more importantly, has any of them either established Shari'ah governance

at a national level or required it at the firm level (though Luxembourg has felt able to achieve a similar effect, for capital market instruments by interpreting its regulations to require disclosure of Shari'ah governance arrangements (Lff 2014)).

The extremely limited regulatory change among the European centres is no doubt partly attributable to the fact that any material change would have to take place at a European level, and to be negotiated at that level. Such change, requiring a substantial consensus among many countries, would be likely to be difficult, given the political caution with which even the UK has needed to proceed. The fact that these countries have an essentially identical regulatory regime does, however, allow interesting comparisons to be drawn in other areas. The European centres also share the characteristic that, because of the European single market, a business established there has very wide freedoms to offer its services across the European community. There are also wide freedoms for financial products. So, for example, a CIS based in Luxembourg in accordance with the UCITS framework can be offered across the EU. This means that there is a degree of competition among European centres to be the point of entry to Europe for businesses based outside, and the size of each country's domestic market need not be the dominant factor in achieving this.

As regards sukuk, although they are (like conventional bonds) capital market instruments and are regulated as such, they trade very little and do so largely over the counter.⁶¹ As a result, they are not particularly profitable businesses for an exchange since the main income they offer comes from listing fees (and on the other side the quality of the exchange's secondary market is of limited relevance to the issuer). However, structuring and marketing sukuk are important and remunerative activities for investment banks and lawyers in particular. It is supporting businesses like these that have most to gain from a centre establishing itself as an important one for sukuk.

To consider what the five centres have achieved in Islamic finance, it is helpful to place their positions in a global context. As regards banking, IFSB (2016) places the UK with 0.3% of Islamic banking assets globally and in 16th place. None of the other four countries appears in the first 16. Similarly, none of the centres have a material presence in Takaful (IFSB 2016), though the data here excludes Retakaful. The capital markets data is more interesting. Figures for sukuk issuance in the first 11 months of 2015 by domicile of ultimate obligor show Malaysia in first place, with 50.4% of issuances, followed by Indonesia (13.2%) and Saudi Arabia (11.8%). Hong Kong is in eighth place with 1.7% as a result of its sovereign issuance (IFSB 2016). This is, however, of limited relevance to the significance of various centres as venues for capital raising. Figures for sukuk listings are helpful but are quite volatile and complicated by sukuk being listed on multiple exchanges. However, in mid-2016, NASDAQ Dubai claimed the highest level of sukuk listings, ahead of Kuala Lumpur, London and Dublin (Kane 2016). More relevant data is, however, available for Islamic CIS, where data is available by fund domicile as at the end of October 2015. Saudi Arabia leads with 40%, followed by Malaysia, Jersey and the USA. Luxembourg is in fifth place with 4%. Singapore has 1% (IFSB 2016). Taken together, these figures show that none of the jurisdictions have major importance outside capital markets, and even where they do achieve significance at all is subject to very strong challenges.

⁶¹ Tendulkar & Hancock (2014) have data on the low rates of bond turnover in general, though unfortunately not for the centres studied here. Corporate bonds have in general lower turnover than government bonds and emerging markets have in general lower turnover than developed ones. The London Stock Exchange's website shows that in the last 6 months of 2015, Emaar's sukuk had just 3 trades

Germany

Germany has made no attempt to become a major player in Islamic finance. This may be in part because its banking and capital markets activities tend to be more focused on Europe than broader international business. But whatever the reason, it is clear that Germany has approached Islamic finance with some caution. It has made no strategic attempt at the government or other authoritative level to establish an international position in this area. It has even been prepared to be accommodative of attempts to provide Islamic financial services to its Muslim minority, though the limited success so far suggests that demand, among a Westernised minority in a mixed financial system, is rather “soft”.

This contrasts with the position of major German financial businesses. In particular, Deutsche Bank is a major player as an investment bank in the capital markets, structuring sukuk and providing services such as custody. It has published at least one important – though much contested – structure (DB undated). But all this work is done outside Germany, Dubai and London being the most important centres. The German insurance and reinsurance industry has also established an important presence in Takaful and Retakaful, with Munich Re, Hannover Re, Allianz and FWU all significant in rather different roles. But again, this business is being done in a variety of Muslim majority countries, though with perhaps more direction from Germany than in the case of Deutsche Bank.

Luxembourg

Luxembourg is a relatively straightforward example of a centre that has specialised strengths, in capital markets and especially as a domicile for collective investment schemes and has extended these to the Islamic market, supported by active government promotion. It has already established itself in conventional finance as a point of entry to Europe for CIS in particular and its attractions (especially in speed of response) could readily be extended to Islamic finance. Its position is supported by the fact that there are supporting businesses, for example lawyers, for whom the Luxembourg CIS regime is tried and tested and who are geared to establishing funds within this regime very efficiently.

These features are true to a lesser extent of the sukuk business where Luxembourg has, however, had the advantage of being better geared than the UK-influenced jurisdictions to continental systems of law and business structures; it has, therefore, had some edge in dealing with businesses wanting to use such systems.

Hong Kong

The natural Asian comparator for Luxembourg is Hong Kong. Hong Kong also has a minimal Muslim population, and has therefore focused on its capital market strengths, especially as a bridge between China and outside markets. It has done this with active government promotion aimed at one particular segment, in this case sukuk. Its government has explicitly acknowledged as an objective the tapping of surplus liquidity in the Islamic world for investment into China. Hong Kong has, however, been rather slower off the mark than Luxembourg and its tax changes in particular have taken some time. There are some hints (for example the fact that the central bank took the lead on Islamic finance ahead of the capital markets authority) that there may not have been a common level of enthusiasm for the project across government, but this is not a clear inference.

Although it has undertaken a demonstration project by issuing two sovereign sukuk, Hong Kong has not as yet gained traction in the sukuk market more generally. It appears that, in any event, Chinese companies have been slow to be convinced of the merits of raising money by

this route when they have wide access to other parts of the international capital markets. At the same time, the falling oil price has reduced surplus liquidity in a number of important Islamic countries. In addition, the tax incentives available in Malaysia mean that Hong Kong has serious competition to overcome in challenging for Asian issuances.

The Hong Kong interest in Islamic REITs has also, so far, led nowhere, despite a very active property market in that jurisdiction. One reason may be the challenge of putting together a viable and attractive proposition when other elements of an Islamic financial system, notably Islamic mortgages, are not in place there. In addition, the requirement that property uses be Shari'ah compliant⁶² limits the use that can be made of REITs in the commercial property sphere.

Singapore

Hong Kong's traditional rival as a financial centre for Asia has been Singapore. Singapore moved more quickly into the field perhaps because of its proximity to Malaysia and with a domestic Muslim minority as a possible target for retail offerings. Like Hong Kong, it has had a strategic approach, formulated and driven by government. That approach has been broader than Hong Kong's, covering banking and Takaful as well as capital markets, and it has included education and supporting professions. However, that approach has not been uniformly successful. Islamic banking has struggled to gain scale and Takaful has proven to be a failure at the retail level. As in the case of Germany, this suggests a rather soft demand in a mixed developed economy, with the Muslim minority of Singapore apparently not showing any marked preference for Islamic products at the retail level. Singapore has been more successful in capital markets where it has achieved a reasonable share of sukuk issuances but its presence in the collective investment funds market is limited.

With a more limited retail market than might initially have been expected, Singapore, like the other centres discussed in this chapter, is finding that it is pursuing mainly internationally mobile business. In this context, one critical issue is its proximity to Kuala Lumpur. The two cities are close enough (a little closer than Frankfurt and Munich) that they can effectively share the "soft" elements of Islamic finance infrastructure – education, lawyers, other advisers, etc. So the challenge for Singapore will always be, "Why should the business be done here rather than in Malaysia?" especially when Singapore's more active secondary market is of only marginal relevance. On the other hand, this does allow Singapore's supporting professions, like lawyers, the ability to benefit from Islamic finance business done in its neighbour. There are no hard data to indicate the extent to which this is happening, but several law firms⁶³ list Islamic finance teams based in Singapore.

Singapore's great strength is its position as a regional hub across a wide spread of financial services. It is one of two natural choices (the other being Hong Kong) for a financial services firm from outside seeking to establish an Asia-Pacific regional headquarters. It is therefore likely that it will benefit from growth of Islamic finance in the region, through headquarters functions as well as through the supporting professions, even if that business is ultimately booked through other centres.

⁶² Or alternatively the impact on returns of purifying non-compliant income.

⁶³ Including Norton Rose Fulbright, Linklaters, Clifford Chance, and Allen & Overy

UK

The UK, like Singapore, is a leading financial centre globally, with a Muslim minority smaller in percentage terms but larger in absolute terms than Singapore's. Like Singapore, it has been pursuing Islamic finance with a government-driven strategy, for a significant time, and with an eye to both retail and wholesale business. Also like Singapore, it has found that demand among its own population has been sufficiently soft that firms offering Islamic financial products in the retail market have struggled to reach a viable scale.

The UK has, however, benefited from a very deep infrastructure, in education, in professional institutions (for example CISI), in lawyers and accountants, and from the fact that English law has been a common choice of law in international transactions, including the issuance of sukuk. This depth has allowed it to attract attention with innovative structures, the demonstration of which seems to have been a tacit part of the government's strategy. It has also built, and continues to build, an infrastructure for Islamic banking, notably in the area of liquidity management.

The UK has benefited from historic links with the Middle East, which have made it a centre for wealth management and investment from the region. For example, the sovereign wealth funds of Abu Dhabi, Kuwait and Qatar all have investment offices there (TheCityUK 2015b). Its Islamic finance offerings have therefore served traditional clients and have been built on traditional strengths. It has established a strong position in sukuk listings and in asset management a number of private deals have been structured on Islamic principles.⁶⁴ Similarly, the Cobalt Takaful facility is based on London's traditional strengths in insuring large commercial risks.

5.4. Lessons for Islamic Finance

The cases of international financial centers show that Islamic finance is operating in these jurisdictions with minor changes in tax laws but with no fundamental changes in the conventional regulatory regimes and with no regulatory Shariah governance frameworks. This paradox can be partly explained by examining the Islamic financial sectors operating and the clients served in these centers. In particular, other than UK and Singapore that have some retail practices, other jurisdictions have focussed more on capital markets and retakaful services. One jurisdiction (Germany) has made no attempt to promote Islamic finance. It has, at best, found a way to accommodate it within its existing regime. German businesses, acting independently, have tried to establish positions, but often through operations in other jurisdictions. Of the remainder, while Hong Kong and Luxembourg have focused their ambitions on international capital markets activities neither would expect to have a domestic Islamic market. These international capital markets have also been a material part of the ambitions and activities of the UK and Singapore.

Capital market and retakful sector practices are sophisticated and require sound legal and regulatory foundations. All five jurisdictions studied provide very strong infrastructural institutions for these sectors in conventional finance. This means that, as far as internationally traded business is concerned, they start out with the advantages of a strong conventional infrastructure, active exchanges, legal communities familiar with their regimes, etc., which are prerequisites for complex financial transactions. They are all known as places in which to raise

⁶⁴ See, for example, <http://www.gatehousebank.com/gatehouse-news>.

funds from institutional and large investors (or, in the case of Luxembourg, to register collective investment schemes). The advantages of a sound financial architecture to carry out complex financial transactions are important for issuers and investors alike. It is hardly surprising that some issuers of sukuk will wish to issue and/or list them in places where they are best able to contact investors. This is because these activities are conducted largely with sophisticated, often institutional, investors who are able to articulate the provisions and disclosures they need, especially in Shari'ah matters. Some will be able to take their own Shari'ah advice if necessary. In the one area with a strong retail component – collective investment schemes – Luxembourg uses general powers to mandate disclosure but any substantive Shari'ah requirements will in any event be those of the jurisdictions into which the funds are sold.

Similar reasoning applies to some of the business in other sectors. For example, the London market Takaful offering is for large commercial risks and reinsurance, again aimed at sophisticated buyers. Some of the UK's banking activity is also aimed at an international market which, in itself, implies relatively affluent and sophisticated customers.

As indicated, only the UK and Singapore have made an effort to develop retail Islamic finance offerings for their domestic markets. Both have found it difficult and both Islamic retail banking and takaful have remained niche offerings. This has some consequences. It means that the market cannot generally support many players, and competition is likely to be more from conventional than other Islamic players. Thus, the issue of a level playing field within the Islamic market, which is in other jurisdictions one of the arguments for central Shari'ah governance is largely absent. On the other hand, as the a majority of retail customers use Islamic finance due to religious reasons, financial institutions have every incentive to stress their Shari'ah compliance and how their offerings differ, to distinguish themselves from conventional competitors. Thus, these organizations would institute Shariah governance mechanisms at the organizational levels as market practice to satisfy their customers.

Given the above arguments, it follows that examples of retail practices of UK and Singapore cannot readily be transposed to Muslim majority countries. They are relevant primarily to Muslim minority countries which already have strong positions in conventional finance. However, lessons can be learnt from the international financial centers for the development of Islamic capital markets and retakaful sectors. As these segments constitute complex and sophisticated transactions, there is a need to come up with a sound financial architecture that can support the development of these sectors in OIC MCs.

5.5. Summary and Conclusions

Overall, it can reasonably be said that two centres (London and Luxembourg) have clearly established strong positions in Islamic finance in areas where they were previously strong conventionally. Singapore appeared to have done the same, though more recently its success has looked more fragile. Hong Kong has so far failed to establish a position. Germany has, at a strategic level, not attempted to do so, though that has not stopped German firms becoming significant players through their operations in other countries.

Table 5.5 summarises what the centres studied have achieved. Note that it deals with what is available in the centre in question, not what its firms have achieved elsewhere. Note also that, in several cases, although the activity is present, it is on a small scale.

Table 5.5: Summary Status of Activities in Global Financial Centres

Activities	UK	Germany	Luxembourg	Singapore	Hong Kong
Retail Banking	Yes	Yes	No	Yes	No
Wholesale Banking	Yes	No	No	Yes	No
Takaful/Retakaful	Yes	No	No	Yes	No
Funds	Yes	No	Yes	Yes	Yes
Sukuk	Yes	No	Yes	Yes	Yes
Education/Training Programmes	Yes	Yes	Yes	Yes	No

In trying to draw lessons and conclusions from this analysis, one can look at the implications for other global financial centres with an interest in Islamic finance, or at the implications for OIC countries considering whether their centres may be able to challenge the existing global centres on the back of an Islamic finance specialism. It is easier from this study to draw conclusions about the former than the latter.

First, it is necessary to set some context. Islamic finance is less than 2% of the global financial system. Some 80% of its assets are in the banking sector, of which 37% are in Iran, 19% in Saudi Arabia, 9% in Malaysia and 8% in the UAE. Other GCC countries account for a further 13% (IFSB 2016). Even given the very high growth rates of Islamic finance, the amount of truly contestable business, for international financial centres outside those countries is at present small. It is therefore unrealistic to think that every significant financial centre in the world can hope to achieve a viable scale in Islamic finance, even if it wanted to do so.

Several centres besides those discussed have challenged actively for the contestable market and some have achieved an important presence in it. In Asia, although Kuala Lumpur does not have a strong pre-existing position in conventional finance, it has had the benefits of a very active government development strategy supported by regulatory underpinning, active promotion, and incentives. Both Singapore and Hong Kong have, in practical terms, been in competition with Kuala Lumpur for internationally mobile business, even leaving aside challenges from other centres and other regions. In the Middle East, several centres have been vying for business and in Europe there is again competition, with Dublin and Jersey having a significant presence in parts of the market, and ambitions from other centres such as Paris.

The evidence from the centres under study is that the demand for Islamic financial products from Muslims in developed countries operating mixed financial systems is relatively soft. Islamic products need to be fully competitive with conventional ones for a religious preference to operate in their favour. This in turn means that they cannot bear substantial additional distribution costs, even if they are targeted at a dispersed minority of the population. Achieving a viable scale is not easy as has been demonstrated in the UK, Singapore and Germany.

It follows that the presence of a Muslim minority is of limited direct value to a centre seeking to establish itself in Islamic finance (though it may have indirect benefits in offering a talent pool from which to recruit, and greater knowledge of Islam among the population generally). It is likely that established trade, financial and educational links with major Muslim-majority countries will be much more valuable in establishing a presence than the presence of a domestic minority.

The centres which have succeeded have built on their existing strengths and have essentially extended (parts of) their existing offerings into the Islamic field. All have made adjustments to their tax systems to provide effective parity of treatment between Islamic products and their

conventional counterparts but, interestingly, none have made or sought any major adjustment to their financial services regulation. Where changes have been made, they have generally been to allow firms to provide Shari'ah-compliant products without artificial restrictions (for example on ownership of real estate in an Islamic mortgage).

All the centres except Germany have seen a need for active promotion of their offerings in Islamic finance and have sought to be visible in public fora. They have also sought to demonstrate their commitment and, often, the effectiveness of their legal frameworks, by issuing sukuk even where this was not necessary for government financing purposes. In some instances, particularly for London, there has been an attempt to demonstrate the depth of the centre's capability by pioneering novel structures. The export credit-backed sukuk for Emirates is an obvious example. This is an example of trying to utilise the strengths of the centre's "soft infrastructure" though, interestingly, none of the centres has made a strong strategic attempt to develop that infrastructure. Although in some there have been important developments in education or in professional services, these have in general been allowed to arise spontaneously rather than being driven by government strategy. Singapore is the only one of the centres where the government has claimed direct credit for educational initiatives.

It is clear, however, that while government promotion and demonstration may be a necessary condition of success, they are not a sufficient one, even when combined with a strong pre-existing position as a conventional financial centre. The relative lack of success of Hong Kong and the difficulties of Singapore in some sectors are a demonstration of that.

For a financial centre to succeed in attracting globally-mobile Islamic financial business, therefore, it must compete with other centres and have at least some element of its selling proposition that will give it an advantage. That will be difficult, more so since many of the European centres will necessarily follow the same regulatory model and be unable to distinguish themselves on that ground. Some centres may have advantages of language or historic ties, for example within the Russian-influenced countries of Central Asia, or the Francophone countries of Africa. Some may have particularly strong positions in parts of conventional finance (as, for example, Bermuda has in reinsurance), but otherwise it is difficult to see what might distinguish a new entrant.

There is, however, also a category of regionally-mobile business. Typically this will be business where there is deemed to be an advantage in carrying it out close to investors or other counterparties but which do not have to be done in a particular jurisdiction. Some capital market businesses are of that kind, as are various headquarters and back office functions. For example an insurer may choose to concentrate specialised underwriting skills in a global or regional centre. In such cases, the competition for location will be complex. Issues of economies of scale will be relevant as will synergies between the firm's Islamic and conventional business. This does allow another route for conventional centres to benefit in employment terms from Islamic business, even if that business is booked elsewhere.

6. Overview of the Islamic Financial Architectural Institutions: Weaknesses and Prospects for Further Development

Based on the country case studies, this section will evaluate the status of the financial architectural institutions and identify the gaps that can potentially inhibit the sound growth of the Islamic financial industry. The statuses reveal the weaknesses and strengths of various Islamic infrastructure institutions from different countries. The financial architectural issues will be discussed under the headings of the seven key categories identified above (i.e., legal infrastructure, financial system supervision and regulation, Shariah governance framework, liquidity infrastructure, information infrastructure and transparency, consumer protection architecture, and human capital and knowledge development framework).

The results are presented in three sections. First, the statuses of different architectural institutions at the national levels are presented. Second, the overall rankings of each infrastructure institution across different countries are evaluated. Finally, the positions of international institutions in providing support to develop the infrastructure institutions are presented.

6.1. Infrastructural Institutions: Statuses at the National Levels

6.1.1. Legal Infrastructure

As indicated, the status of different aspects of the legal infrastructure can be viewed in two ways. First, the relative institutional statuses of individual countries are presented. Second, the overall status of the institution across countries is discussed.

Supporting Financial Laws

The case studies show a variety of legal regimes under which Islamic financial sectors operate. The first category is an Islamic legal system and all its financial laws and institutions support the Islamic financial sector (Sudan).⁶⁵ Other countries have dual financial systems where conventional and Islamic financial institutions operate side by side. Among these, some countries have enacted separate laws for the Islamic finance sector (Malaysia, Oman). In a third group of countries, the existing financial laws are adjusted to accommodate Islamic finance (Bangladesh, Indonesia, Pakistan). Note that in case of Turkey, while the banking law and capital markets law includes elements of Islamic finance, the insurance law does not. In a fourth type, the central banking laws give authority to regulate different financial institutions including Islamic ones. In these countries the regulators provide the bulk of the legal/regulatory framework for the Islamic financial sector. In the last group of countries, there are no specific provisions for Islamic finance in the finance laws but the regulators tolerate Islamic financial institutions (Egypt, Saudi Arabia and Senegal).

⁶⁵ Iran is the other country that has both an Islamic legal and financial system. While Saudi Arabia's legal system is Islamic, the financial sector has both Islamic and conventional components.

Table 6.1: Status of Islamic Financial Laws

Legal Infrastructure: Financial Laws	Countries		
	Banking	Takaful	Capital Markets
1. Islamic Legal System	Sudan	Sudan	Sudan
2. Separate Islamic Financial Laws	Malaysia,	Malaysia, Oman	
3. Islamic Finance in Existing Financial Laws	Bangladesh, Indonesia, Oman, Pakistan, Turkey, UAE	Bangladesh, Indonesia, Pakistan	Bangladesh, Indonesia, Malaysia, Oman, Pakistan, Turkey
4. Law Provides Authority to Regulators to Issue Regulations on Islamic Finance	Nigeria	Nigeria, UAE	Nigeria, UAE
5. Single Finance Law	Egypt, Saudi Arabia, Senegal	Egypt, Saudi Arabia, Senegal, Turkey	Egypt, Saudi Arabia, Senegal

Tax Laws

The key issue related to tax laws appear in countries with dual financial systems where taxes make the Islamic financial products more expensive relative to their conventional counterparts. Some facilitative countries proactively change the tax laws to level the playing field between conventional and Islamic financial institutions. Accordingly, countries can be grouped into three types when it comes to implications of tax laws. The first group is one in which tax laws are not relevant in Islamic finance either because the conventional financial sector does not exist (Sudan) or because there are no taxes that specifically affect the Islamic financial sector (Saudi Arabia and UAE).

Table 6.2: Status of Tax Laws to Accommodate Islamic Finance

Legal Infrastructure: Tax Laws	Countries
Not Applicable	Saudi Arabia, Sudan, UAE
Tax laws changed/ accommodated	Bangladesh, Indonesia, Malaysia, Oman, Pakistan, Turkey
No change in tax laws	Egypt, Nigeria, Senegal

Countries in which the governments have taken a facilitative role and change tax laws to level the playing field for Islamic finance are Bangladesh, Indonesia, Malaysia, Oman, Pakistan and Turkey. Countries where tax laws have not been changed are Egypt, Nigeria and Senegal. One of the implications of not changing tax laws is that Islamic financial institutions tend to structure their products very similar to their conventional counterparts to lower the costs of their products.

Dispute Resolution

Other than countries in which the legal system is Islamic, civil courts use the laws of the country. The case studies show different arrangements for resolving disputes arising in the Islamic financial sector. In countries with Islamic legal systems, the courts will apply Islamic law and there may not be any need for special courts. However, in Saudi Arabia there is a special committee that deals with cases involving the financial sector. The second group of

countries has an arrangement for getting Shariah input for cases involving Islamic finance in civil courts. Even though Islamic financial disputes will be tried in civil courts in Oman, the court uses Shariah in dealing with contracts. In Pakistan, there is a Shariah appellate court and in Malaysia a bench in the high court deals with disputes related to Islamic finance. The courts in these countries refer any Shariah related issues to a central Shariah Advisory Council/Board for suggestions. The third group of countries have Islamic arbitration centers. Countries in this group include Indonesia, Malaysia, Sudan and UAE. The final group does not have any specific arrangements for Islamic finance cases and disputes will be adjudicated in civil courts using the laws of the country. The lack of dispute resolution framework in Bangladesh, Egypt, Nigeria, Senegal and Turkey introduces legal risks in Islamic finance.

Table 6.3: Status of Dispute Resolution Framework for Islamic Finance

Legal Infrastructure: Dispute Resolution	Countries
Islamic Courts	Saudi Arabia, Sudan
Dispute Resolution for Islamic finance (Shariah inputs in civil courts)	Malaysia, Oman, Pakistan
Dispute Resolution for Islamic finance (arbitration centers)	Indonesia, Malaysia, Sudan, UAE
Civil courts	Bangladesh, Egypt, Nigeria, Senegal, Turkey

Bankruptcy Framework and Resolution of Banks

The bankruptcy framework and resolution of banks framework in the case studies can be separated into two categories. Firstly there are countries that have specific issues in their bankruptcy and bank resolution framework that have specific issues dealing with unique features of Islamic finance (Malaysia, Oman, Pakistan and Sudan). Secondly, in the remaining countries a single bankruptcy framework applies to all financial institutions including the Islamic ones.

Table 6.4: Status of Bankruptcy Framework

Legal Infrastructure: Bankruptcy and Resolution of Banks	Countries
Specific bankruptcy for Islamic finance	Malaysia, Oman, Pakistan, Sudan,
Single bankruptcy/resolution arrangement	Bangladesh, Egypt, Indonesia, Nigeria, Saudi Arabia, Senegal, Turkey, UAE

6.1.2. Regulation and Supervision

The case-studies show different types of overall regulatory frameworks for various financial sectors. While there may be a single regulatory body for all three financial sectors (such as OJK in Indonesia), in most other countries there are multiple regulatory bodies for various sectors. A few countries separate individual regulators for each of the three sectors (such as Bangladesh, Nigeria, Senegal, Sudan, Turkey, and the UAE). In most of these countries the central bank regulates the banking sector and in some countries it also regulates the insurance/takaful sectors (e.g., Malaysia, Saudi Arabia). The capital market is regulated by separate capital market regulators and in some cases this regulatory body also regulates the insurance/takaful sectors (Egypt, Oman, Pakistan).

The regulatory framework for Islamic finance in different countries can be assessed by examining two institutional aspects: whether there is separate regulatory framework for Islamic finance that is overseen by a specific department and whether specific regulatory initiatives have been taken for Islamic finance. Note that while the former would usually imply the later, there may be some cases where regulators may issue specific regulations related to Islamic finance but do not have a separate department looking after regulatory issues of Islamic finance. Category 1 is a robust regulatory framework where a country has specific regulations related to Islamic finance that is overseen by a separate department that oversees the Islamic financial sector. Countries in this group for the Islamic banking sector are Indonesia, Malaysia, Oman, Pakistan and Sudan. All these countries, except Oman also have a robust regulatory framework for the takaful and capital markets sectors. The second category of countries are countries that do not have a separate department to deal with Islamic finance but have separate regulatory guidelines for the industry. Countries in this category are Nigeria and the UAE for all financial sectors and Oman for takaful and Islamic capital markets. The third category of countries has the weakest regulatory framework with neither a department nor specific regulations for Islamic finance. The countries included in this category are Egypt, Saudi Arabia, Senegal and Turkey. Note that while in Bangladesh the regulatory body for the banking sector has taken initiatives for Islamic banks, this is not the case for the takaful and capital markets sectors.

Table 6.5: Status of Regulatory Framework

Institutional Setup	Financial Sectors		
	Banking	Takaful	Capital Markets
a) Independent/separate regulatory department and b) specific regulatory initiatives taken for Islamic finance	Indonesia, Malaysia, Oman, Pakistan, Sudan	Indonesia, Malaysia, Pakistan, Sudan	Indonesia, Malaysia, Pakistan, Sudan
a) No independent/separate regulatory department and b) specific regulatory initiatives taken for Islamic finance	Bangladesh, Nigeria, UAE	Nigeria, Oman, UAE	Nigeria, Oman, UAE
a) No independent/separate regulatory department and b) no specific regulatory initiatives taken for Islamic finance	Egypt, Saudi Arabia, Senegal, Turkey	Bangladesh, Egypt, Saudi Arabia, Senegal, Turkey	Bangladesh, Egypt, Saudi Arabia, Senegal, Turkey

6.1.3. Shariah Governance

The status of Shariah governance can be determined by different factors. First, the existence of legal or regulatory requirements or guidelines related to Shariah governance issues. This would be in the form of either the law and/or regulations specifying rules for a Shariah governance framework at the financial institution level. Second would be the existence of a national Shariah board to provide rulings and guidance to the Islamic financial sector on Shariah related issues. Finally, some Shariah standards or parameters, either national or international, exist that financial institutions are required to follow.

The status of Shariah governance regimes according to the criteria identified above in case-study countries are shown in the table below. Three countries (Indonesia, Malaysia and Pakistan) have robust Shariah regimes which have all three aspects of Shariah governance elements. That is, they have laws/regulations regarding Shariah governance for financial

institutions, have a national Shariah board and also have issued Shariah standards/parameters for Islamic financial transactions. A second group of countries have legal/regulatory requirements for Shariah governance and a central Shariah authority for certain financial sectors. Bangladesh, Nigeria, Oman and Sudan fall under this category of countries. Note that while in most countries the central Shariah board is introduced by the regulators, in Indonesia it is established by the Ministry of Religious Affairs and in Bangladesh the Islamic banks have taken this initiative with the encouragement of regulators.

A third group of countries have weaker Shariah governance regimes with only laws and/or regulations mentioning some sort of Shariah governance but no specific guidelines on their form or structures. UAE falls in this category. In the last group of countries (such as Saudi Arabia, Senegal and Turkey) there are no legal/regulatory initiatives for Shariah governance. Note that there are some sector wise disparities in the Shariah governance regimes for different sectors. For example, in Bangladesh the banking sector has a central Shariah board, but the takaful and capital market segments do not have one. Similarly, there is the regulatory framework for Shariah governance for the takaful sector in Egypt for which there are no corresponding requirements for the banking and capital market segments in the country.

Table 6.6: Status of Shariah Governance Regimes

Institutional Setup	Financial Sectors		
	Banking	Takaful	Capital Markets
Legal/Regulatory requirements for Shariah governance	Bangladesh, Indonesia, Malaysia, Nigeria, Oman, Pakistan, Sudan, UAE	Egypt, Indonesia, Malaysia, Nigeria, Oman, Pakistan, Sudan, UAE	Egypt, Indonesia, Malaysia, Nigeria, Oman, Pakistan, Sudan
Existence of national Shariah Supervisory/Advisory Board	Bangladesh, Indonesia, Malaysia, Nigeria, Oman, Pakistan, Sudan	Indonesia, Malaysia, Nigeria, Oman, Pakistan, Sudan	Indonesia, Malaysia, Oman, Pakistan, Sudan
Shariah standards/parameters	Indonesia, Malaysia, Pakistan	Indonesia, Malaysia, Pakistan	Indonesia, Malaysia, Pakistan, UAE
No Shariah related issues in laws and regulations	Egypt, Saudi Arabia, Senegal, Turkey	Bangladesh, Saudi Arabia, Senegal, Turkey	Bangladesh, Saudi Arabia, Senegal, Turkey

6.1.4. Liquidity Infrastructure

The liquidity infrastructure for Islamic finance would include appropriate Shariah compliant liquidity instruments and money markets in the private domain and the lender of last resort facility provided by the central bank. The case studies show variation in the liquidity infrastructure. A sound liquidity infrastructure for Islamic finance can be found in Indonesia, Malaysia, Pakistan and Sudan where all three elements of liquidity infrastructure identified above are present.

Table 6.7: Status of Liquidity Infrastructure

Liquidity Infrastructure	Countries
Government sponsored liquidity instruments	Bangladesh, Indonesia, Malaysia, Nigeria, Oman, Pakistan, Saudi Arabia, Sudan, Turkey, UAE
Islamic money market	Bangladesh, Indonesia, Malaysia, Oman, Pakistan, Sudan
Lender of the last resort	Indonesia, Malaysia, Nigeria, Pakistan, Saudi Arabia, Sudan
No specific elements in liquidity infrastructure	Egypt, Senegal

In some countries, only part of the liquidity infrastructure element exists. For example, while in Nigeria only the liquidity instruments and LOLR facilities exist, there is the Islamic money market that Islamic banks can turn to in case they need to. This may be partly due to the smaller size of the Islamic financial sector and also the relatively nascent nature of the industry. Similarly, Islamic banks in Bangladesh and Oman have liquidity instruments and money market facilities but no Shariah compliant LOLR. While Turkey and UAE have one Shariah compliant instrument that Islamic banks can use to avail funds from the central bank, in Egypt, Saudi Arabia and Senegal none of the elements of an Islamic liquidity infrastructure exist.

6.1.5. Information Infrastructure

The two key elements of the information infrastructure are the accounting and disclosure standards used by Islamic financial institutions and the existence of rating agencies that assess credit ratings and the Shariah compliance of Islamic financial institutions and instruments.

Table 6.8: Status of Information Infrastructure

Information Infrastructure	Countries
Adopted AAOIFI accounting standards	Oman, Sudan
Accommodate Islamic finance in domestic accounting standards	Bangladesh, Indonesia, Malaysia, Nigeria, Pakistan
Rating agencies assessing Islamic financial institutions/sukuk	Bangladesh, Indonesia, Malaysia, Sudan, Pakistan
Rating agencies assessing Shariah compliance	-
No elements of Islamic finance in domestic accounting standards or rating agencies	Egypt, Saudi Arabia, Senegal, Turkey, UAE

Only two countries (Oman and Sudan) in the sample require Islamic financial institutions to use AAOIFI accounting standards. In some countries (Indonesia, Malaysia, Nigeria and Pakistan), the domestic accounting standards are generally used but are adjusted for Islamic financial transactions. In Bangladesh, while Islamic banks are required to use domestic accounting standards, the regulators require some additional disclosure related to Islamic financial instruments. While ratings agencies in some countries provide credit-ratings of Islamic financial institutions and securities such as sukuk, none of them rate their Shariah

compliance. Five countries (Egypt, Saudi Arabia, Senegal, Turkey and UAE) do not have any elements of the information infrastructure for Islamic financial sector.

6.1.6. Consumer Protection & Financial Literacy

Consumer protection and financial literacy have become important aspects of regulatory framework after the GFC. Deposit insurance is also an important aspect of protecting depositors when banks are in distress. Some specific issues arise in the Islamic financial sector for all these aspects.

The case studies show that while the consumer protection framework exists in most of the countries, only four countries (Malaysia, Oman, Pakistan and Sudan) deal with specific issues related to consumers of the Islamic financial sector. Similarly, only four countries have Shariah compliant deposit insurance schemes to protect consumers of Islamic banks (Malaysia, Nigeria, Oman and Sudan). The majority of countries in the sample (Bangladesh, Malaysia, Nigeria, Oman, Pakistan, Sudan and Turkey) have some financial literacy programs that cover material related to Islamic finance.

Table 6.9: Status of Consumer Protection and Financial Literacy

Consumer Protection & Financial Literacy	Countries
Specific Consumer Protection Policies for Islamic finance	Malaysia, Oman, Pakistan, Sudan
Specific Deposit Insurance Scheme for Islamic banks	Malaysia, Nigeria, Oman, Sudan
Specific financial literacy programs for Islamic finance	Bangladesh, Malaysia, Nigeria, Oman, Pakistan, Sudan, Turkey
Common Consumer Protection Policies	Bangladesh, Egypt, Indonesia, Nigeria, Saudi Arabia, Senegal, Turkey
Common Deposit Insurance Scheme	Bangladesh, Indonesia, Pakistan, Saudi Arabia, Turkey, UAE
Common Financial Literacy programs	Egypt, Indonesia, Saudi Arabia,

6.1.7. Human Capital and Knowledge Development

Most of the case-studies countries show that there have been initiatives to provide education and training in Islamic banking and finance at different levels. While in some countries the public bodies such as Banking Institutes operating under the central banks offer courses in Islamic finance, in most countries educational institutions have come forward with development programs related to the discipline. In some other countries, there are also some initiatives at the private sector and NGO levels to enhance the knowledge and skills for the industry.

The organizations involved in providing teaching and promoting research include centers, associations and training institutes.

Table 6.10: Status of Human Capital and Knowledge Development

Human Capital & Knowledge Development	Countries
Initiatives by public bodies	Egypt, Malaysia, Nigeria, Oman, Pakistan, Saudi Arabia, Sudan
Initiatives by educational institutions/universities	Bangladesh, Egypt, Indonesia, Malaysia, Nigeria, Pakistan, Saudi Arabia, Senegal, Sudan, Turkey, UAE
Private sector initiatives including NGOs	Bangladesh, Indonesia, Pakistan, Senegal, Turkey, UAE

6.2. Overall Statuses of Islamic Finance Architectural Institutions

In this section, an evaluation of the infrastructural institutions for the whole sample of 12 countries is carried out. The status of the different elements of the Islamic financial architecture is based on the following criteria: if the infrastructural institution exists in less than 50% of the countries then it will be deemed ‘underdeveloped’ (identified in red in the charts); if the infrastructural institution exists between 50% to 75% of the countries then it will be considered ‘developing’ (identified in amber in the charts); and if the infrastructural institution exists in more than 75% of the countries then it will be rated ‘developed’ (identified in green in the charts).

6.2.1. Legal Infrastructure

Chart 6.1 shows the overall status of the countries with different types of Islamic financial laws. While 75% of the countries have Islamic banking laws, 58.3% have laws supporting the takaful sector and 66.7% laws relate to Islamic capital markets. The results indicate that while on the average the status of financial laws in the sample countries for the banking sector are developed, the legal statuses for the takaful and capital markets are ‘developing’. Thus, there is a need to strengthen the laws for takaful and Islamic capital markets.

Chart 6.1: Legal Infrastructure--Countries with Islamic Financial Laws (% of total)

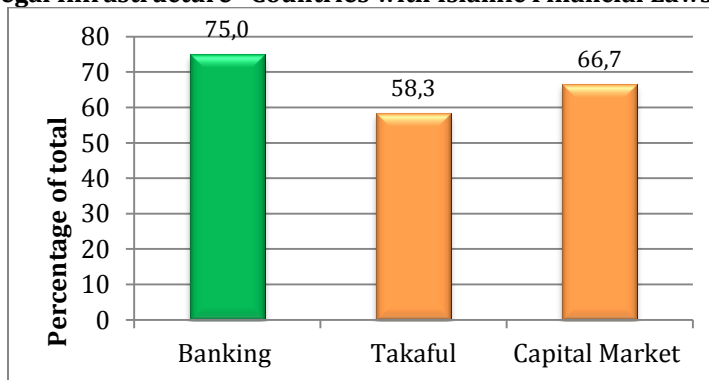
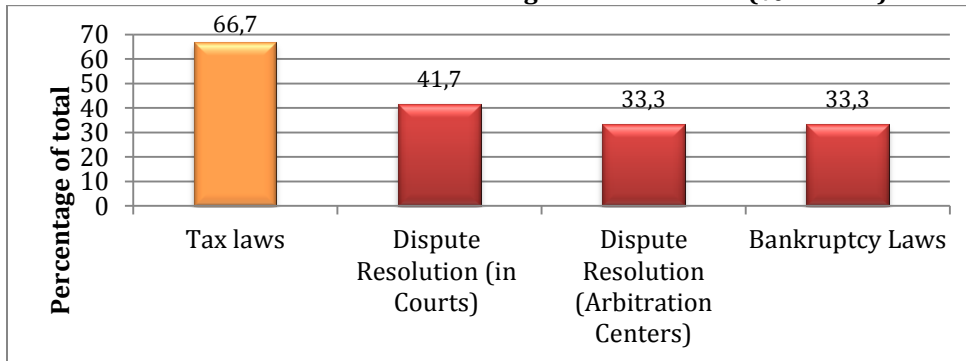


Chart 6.2 shows the status of other legal infrastructure institutions. Note that in three countries the tax laws are not relevant either because the whole financial sector is Islamic (Sudan) or due to the absence of taxes that affect financial transactions (Saudi Arabia and UAE). In the remaining nine countries, 66.7% of them adjust tax laws to accommodate the special features of Islamic finance transactions, thereby leveling the playing field with

conventional finance. Civil courts in 41.7% of the countries in the sample deal with Islamic finance disputes. While some countries (Oman, Saudi Arabia and Oman) use Islamic law to adjudicate cases in courts, other countries (Malaysia and Pakistan) seek advice on Shariah issues from external Shariah boards. One third of the countries (33.3%) have arbitration centers that deal with disputes of Islamic banks and also have bankruptcy laws that deal with issues related to bankruptcies related to Islamic banks.

Chart 6.2: Countries with Islamic Legal Infrastructure (% of total)



In conclusion, while the tax laws in the sample countries have the status of ‘developing’, the other legal infrastructure institutions (dispute resolution in courts and arbitration centers and bankruptcy laws) are ‘underdeveloped’.

6.2.2. Regulation and Supervision

Chart 6.3 shows that in 66.7% of the case-studies, countries have a regulatory framework for Islamic banking and 58.3% have the same for the takafula and capital market sectors. Overall, the average regulatory framework in the sample countries scores the status of ‘developing’. However, relatively fewer countries have specific regulatory departments or units that deal with Islamic financial sectors. Chart 6.4 shows that, while 50% of the countries have a separate department dealing with the Islamic banking sector, only 40% of the countries has such departments for the takaful and Islamic capital market sectors. Thus the institutional arrangements of having separate departments to regulate Islamic financial sectors in the case-study countries are ‘underdeveloped’.

Chart 6.3: Regulatory Framework Islamic Financial Sector

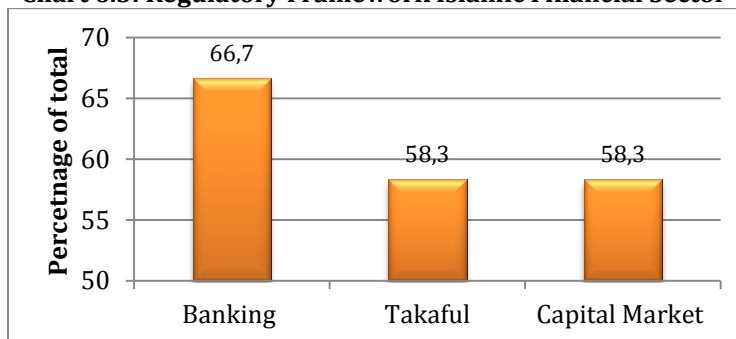
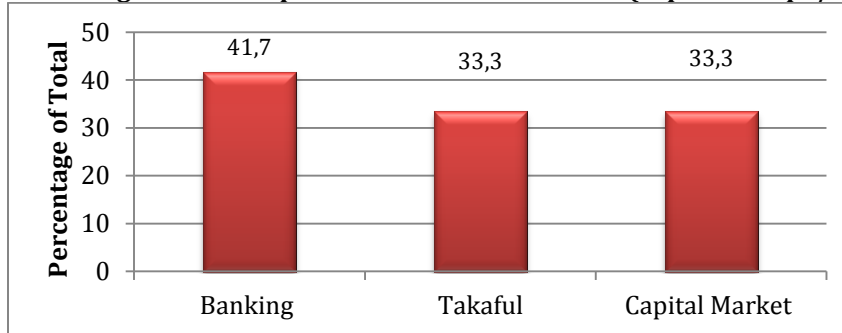


Chart 6.4: Regulation & Supervision of Islamic Finance (Separate Dept./Unit)



6.2.3. Shariah Governance

Chart 6.5 shows that there are regulatory requirements on Shariah governance issues in most countries. While 66.7% of the countries have requirements for Islamic banks and takaful sectors, for capital markets 58.3% of the countries have such requirements. The status of legal/regulatory requirements for Shariah governance for all financial sectors is 'developing'.

Chart 6.6 shows that 58.3% percent of the countries have some kind of central Shariah body overseeing the overall Shariah related issues for the Islamic banking. For the takaful and capital market sectors, the corresponding figures are 50% and 41.7%. Thus, the status of central Shariah boards for banking and takaful sectors is 'developing' and for capital markets it is 'underdeveloped'.

Chart 6.5: Legal/Regulatory Requirements for Shariah Governance

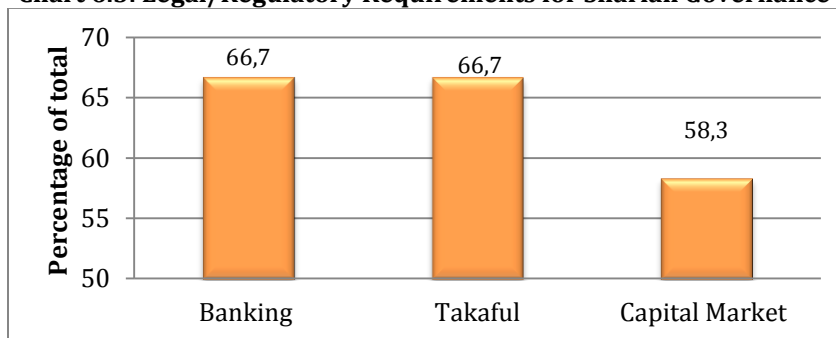


Chart 6.6: Central Shariah Supervisory/Advisory Board

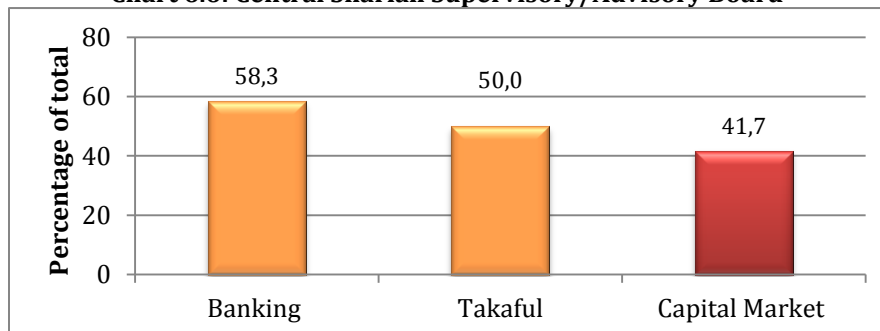
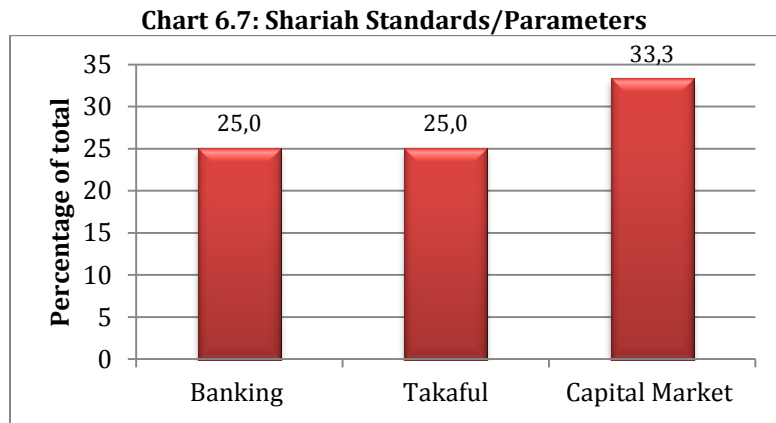
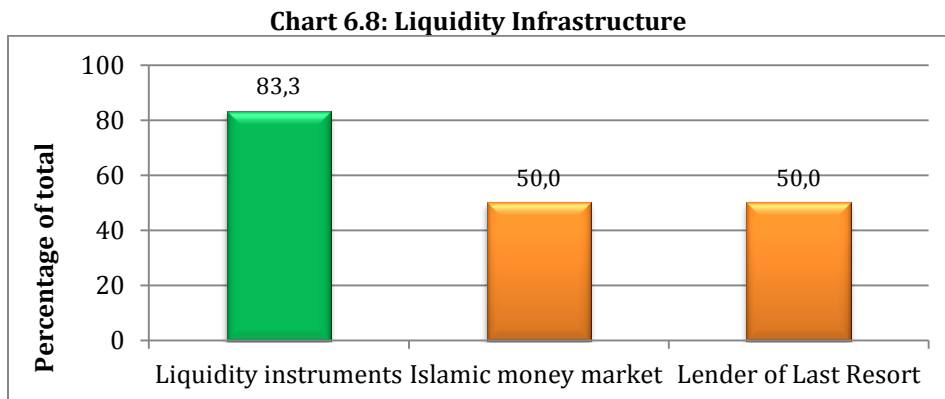


Chart 6.7 indicates that while only 25% of the countries in the sample have developed Shariah standards or parameters for the banking and takaful sectors, 33.3% of the countries have standards for the Islamic financial sector in general and sukuk in particular. The overall statuses of Shariah standards and parameters for all three Islamic financial sectors is 'underdeveloped'.



6.2.4. Liquidity Infrastructure

Chart 6.8 shows the status of different elements of the liquidity infrastructure of Islamic finance. While 83.3% of the countries have some sort of Shariah compliant liquidity instruments, only 50% have Islamic money markets and Shariah compliant lender of last resort facilities. The results indicate that the status of liquidity instruments in sample countries is 'developed' and the Islamic money market and lender of last resort is ranked as 'developing'.

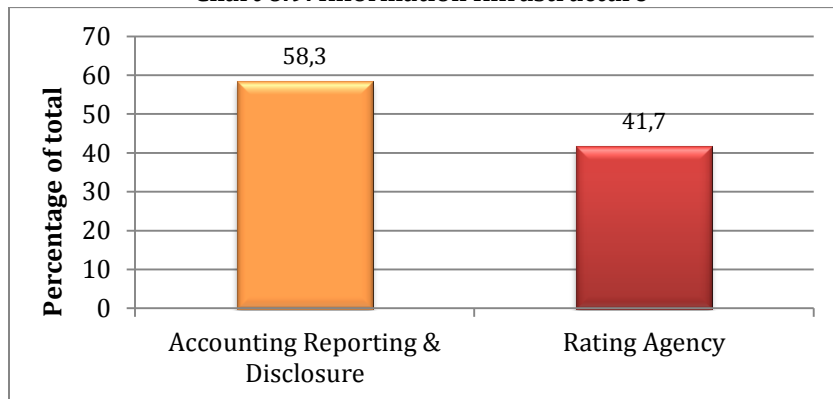


6.2.5. Information Infrastructure

Chart 6.9 shows the status of accounting infrastructure in terms of using accounting reporting and disclosures using Islamic accounting standards and rating agencies that evaluate Islamic financial institutions and instruments. While 58.3% of the countries require using Islamic

accounting standards (either AAOIFI or domestic), only 41.7% have ratings agencies that cater to the needs of the Islamic financial sector. Thus, while the status of accounting reporting and disclosure is 'developing', the ranking of rating agencies for Islamic finance is 'underdeveloped'.

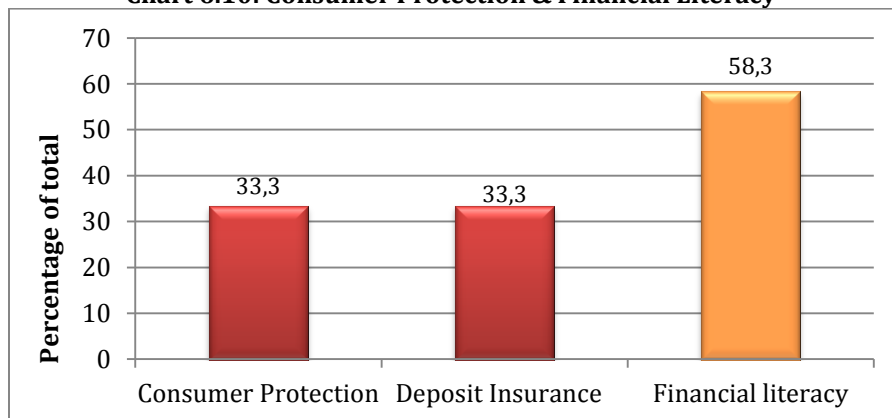
Chart 6.9: Information Infrastructure



6.2.6. Consumer Protection & Financial Literacy

Chart 6.10 shows that only 33.3% of the countries have the consumer protection framework for the Islamic financial sector and have Shariah compliant deposit insurance programs for Islamic banks. In 58.3% of the case-study countries, there are financial literacy programs on Islamic finance. While most of the financial literacy programs come from the regulatory bodies, in a couple of cases the trade associations of Islamic banks promote them. The results indicate that while aspects of consumer protection and deposit insurance are ranked 'underdeveloped', the status of financial literacy is 'developing'.

Chart 6.10: Consumer Protection & Financial Literacy



6.2.7. Human Capital and Knowledge Development

Chart 6.11 shows the initiatives taken in countries by different institutions. Though in 66.7% of the countries the public bodies have institutions providing education and training in Islamic banking and finance, in 58.3% of the countries there are private sector initiatives to do the

same. In an overwhelming 83.3% of the countries, universities and academic institutions are providing education in the discipline. Thus, while the initiative for human capital and knowledge development is ‘developed’ at the academic level, it has a status of ‘developing’ for public bodies, the private sector and nonprofits. Note that one of the key gaps in human capital in Islamic finance exists in public bodies such as regulators and the judiciary. Some countries are unable to come up with appropriate policies for the industry due to a lack of knowledge and skills related to the Shariah principles and practices of Islamic finance.

Chart 6.11: Human Capital and Knowledge Development

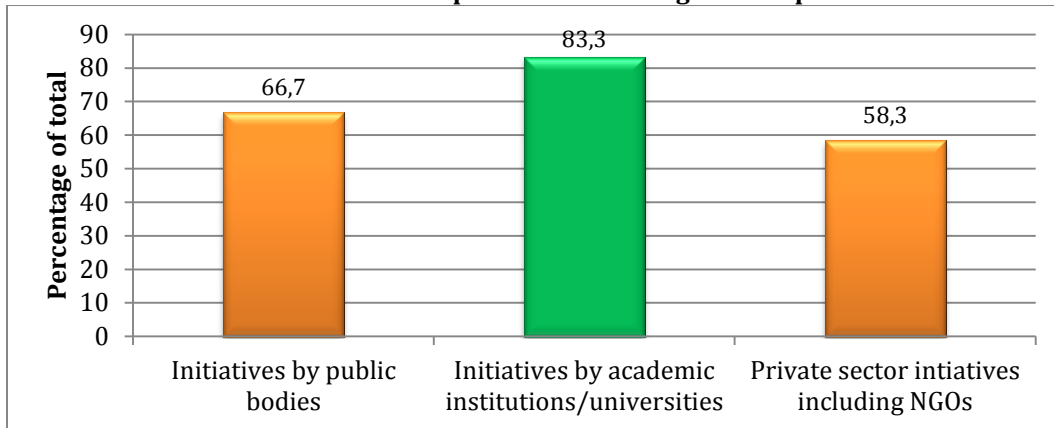
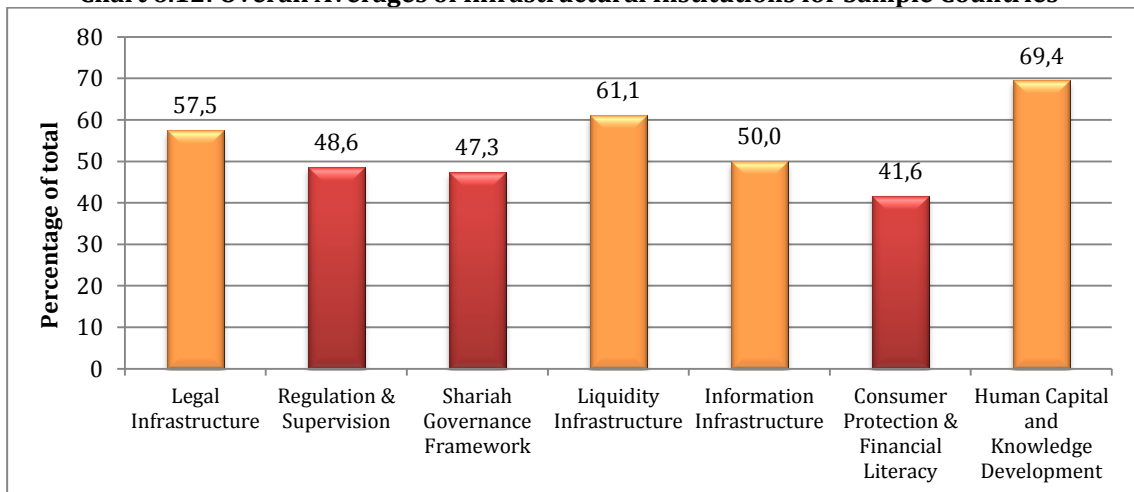


Chart 6.12 shows the overall averages of different Islamic finance infrastructure institutions for sample case-study countries arrived at by averaging the different elements of each infrastructural component. The chart shows that while some of the infrastructural institutions have the status of ‘developing’, others are ‘underdeveloped’. Specifically, the legal, liquidity and information infrastructures, and human capital and knowledge development aspects of the Islamic financial sector can be ranked as ‘developing’; and regulations and supervision, Shariah governance framework, and consumer protection and financial literacy are ‘underdeveloped’. As none of the architectural elements show a ‘developed’ status on average, there is a room for the development of all aspects of the infrastructural institutions, particularly in the latter types.

Chart 6.12: Overall Averages of Infrastructural Institutions for Sample Countries



6.3. Infrastructure Institutions at the International Level

As the Islamic financial industry grows, there are certain issues that can facilitate the promotion of the Islamic financial industry and architecture at the national levels. Furthermore, there are certain cross border operations that would require the harmonization of laws and regulations and standardized accounting and auditing standards to mitigate legal risks. The areas in which the international level institutions provide support and the gaps for different types of architectural institutions are discussed in this section. Note that the way in which these gaps can be filled are discussed in the next chapter.

6.3.1. Legal Infrastructure

Table 6.11 shows that among the legal infrastructure, only one international institution, the International Islamic Center for Reconciliation and Commercial Arbitration (IICRCA) is providing an alternative dispute resolution and reconciliation platform to settle international disputes arising in the Islamic financial industry applying Islamic law for disputes. However, in other areas of the infrastructure, there are no other international bodies contributing to supporting the legal framework for Islamic finance.

Table 6.11: International Institutions Related to Legal Infrastructure

No.	Institutional Elements	Existing Institutions	Role and Responsibilities
1.1	Islamic financial laws		
1.2	Supporting Laws for Islamic Financial sector		
1.3	Appropriate dispute resolution framework	<ul style="list-style-type: none"> IICRCA 	<ul style="list-style-type: none"> Alternative dispute resolution platform for Islamic finance using Islamic law
1.4	Bankruptcy Framework and Resolution of banks		

6.3.2. Regulation and Supervision

While in conventional finance different regulatory standard setting bodies exist for banking (BCBS), insurance (IAIS) and capital markets (IOSCO), the Islamic Financial Services Board (IFSB) is the regulatory standard setter for the Islamic financial sector. It has published standards, guiding principles, guidance notes and technical note for the body of Islamic banks, takaful and Islamic capital markets.

Table 6.12: International Institutions Related to Regulations

No.	Institutional Elements	Existing Institutions	Role and Responsibilities
2.1	Islamic financial regulations	<ul style="list-style-type: none"> IFSB 	<ul style="list-style-type: none"> Publish standards and guidelines for regulations and supervision of Islamic banking, takaful and Islamic capital markets

The specific regulatory and supervisory standards and guidance notes published by IFSB to date are shown in Table 6.13. As can be seen, while the regulatory standards for Islamic

banking and takaful sectors are adequate, there is a need to come up with standards for Islamic capital markets.

Table 6.13: IFSB Standards and Guidance Notes for Different Islamic Financial Sectors

Sectors	Risk Management	Regulations/ Supervision
Banking	IFSB-1, IFSB-13	IFSB-2, IFSB-5, IFSB-7, IFSB-15, IFSB-16, IFSB-17 GN-1, GN-2, GN-3, GN-4
Takaful	IFSB-14	IFSB-11, IFSB-18, GN-5
Capital Markets		

Source: IFSB (2015) and <http://www.ifsb.org/published.php>

6.3.3. Shari'ah Governance Framework

The Islamic Financial Services Board (IFSB-10) and Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) have published Shariah governance principles and standards for Islamic financial institutions. As for developing Shariah standards and parameters, Islamic Fiqh Academy (IsFA) has issued rulings on economic and financial matters relevant for the Islamic financial sector. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has published 54 Shariah standards of different types of Islamic financial contracts. International Islamic Financial Markets (IIFM) has also come up with Islamic financial contracts and products templates related to the capital and money market, corporate finance and trade finance.

Table 6.14: International Institutions Related to Shariah Governance

No.	Institutional Elements	Existing Institutions	Role and Responsibilities
3.1	Legal/Regulatory Requirement for Shariah Governance (SG)	<ul style="list-style-type: none"> IFSB AAOIFI 	<ul style="list-style-type: none"> Published Shariah governance standards for Islamic financial institutions
3.3	Developing Shariah parameters/ standards	<ul style="list-style-type: none"> IsFA AAOIFI IIFM 	<ul style="list-style-type: none"> Issue Islamic legal rulings/resolutions on different issues including Islamic finance Develop Shariah standards and templates for Islamic financial products

6.3.4. Liquidity Infrastructure

One of the problems of establishing a liquid international secondary market for Islamic financial instruments are the differences of legal and regulatory regimes of various countries and also the diversity of Shariah opinions across jurisdictions. Specifically sukuk structures entail various supporting laws such as property, tax, bankruptcy, trust, etc. However, the differences in common law and civil law legal systems and legal institutions and across OIC member countries makes it difficult to come up with unified sukuk structures that satisfy the individual national legal frameworks and requirements (Karim 2015: 228). Similarly, perspectives on Shariah compliant sukuk structures also differ from one jurisdiction to another. This reduces the marketability of sukuk globally making them relatively illiquid.

The Liquidity Management Centre (LMC) helps Islamic financial institutions manage their liquidity mismatch by providing short and medium term Shariah compliant liquidity instruments. The International Islamic Liquidity Management Corp. (IILM) issues short-term *Shari'ah*-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. IIFM has developed some templates for products that can be used in money market transactions. IFSB has published a Technical Note (TN-1) on liquidity issues that covers the development of Islamic money markets. However, there are no specific models or templates for Islamic inter-bank money markets developed. Similarly, though the IFSB has published a working paper that discusses different models of Shariah compliant LOLR facilities, no guidelines or standards have been published yet.

Table 6.15: International Institutions Related to Liquidity Infrastructure

No.	Institutional Elements	Existing Institutions	Role and Responsibilities
4.1	Shariah compliant liquidity instruments	<ul style="list-style-type: none"> IIFM LMC IILM 	<ul style="list-style-type: none"> Develop and Issue short-term Islamic instrument for cross-border liquidity management
4.2	Islamic money market	<ul style="list-style-type: none"> IFSB 	<ul style="list-style-type: none"> Develop templates for Islamic money markets
4.3	Lender of the last resort (LOLR)		

6.3.5. Information Infrastructure

AAOIFI is responsible for developing accounting, auditing and governance standards for Islamic financial institutions and has issued 27 financial accounting standards, 7 governance standards, 2 codes of ethics and one guidance note. IFSB has also issued a standard on disclosure and transparency (IFSB-4) for Islamic financial institutions. The Islamic International Rating Agency (IIRA) provides ratings of Islamic financial institutions and Islamic capital market products. IIRA is the only international rating agency that also carries out the *Shari'ah* Quality Rating (SQR) to assess the status of Shariah compliance in different financial institutions.

Table 6.16: International Institutions Related to Information Infrastructure

No.	Institutional Elements	Existing Institutions	Role and Responsibilities
4.1	Accounting and auditing standards	<ul style="list-style-type: none"> AAOIFI 	<ul style="list-style-type: none"> Develop and publish accounting and auditing standards for Islamic finance
4.2	Disclosure and Transparency	<ul style="list-style-type: none"> AAOIFI IFSB 	<ul style="list-style-type: none"> Develop and publish disclosure and transparency standards for Islamic finance
4.3	Rating agencies	<ul style="list-style-type: none"> IIRA 	<ul style="list-style-type: none"> Provides credit and Shariah ratings for Islamic financial institutions and instruments

6.3.6. Consumer Protection & Financial Literacy

While the IFSB has published principles on Conduct of Business Islamic financial institutions (IFSB-9) and a working paper on consumer protection⁶⁶, there are no standards published on consumer protection yet. IFSB has also published a working paper that outlines different models of Shariah compliant deposit insurance scheme.⁶⁷ However, no guidelines or standards have been issued on either of these institutional elements. Similarly, there is a need to develop a framework for financial literacy programs for the Islamic financial sector.

Table 6.17: Consumer Protection & Financial Literacy

No.	Institutional Elements	Existing Institutions	Role and Responsibilities
4.1	Consumer protection framework for Islamic finance		
4.2	Deposit Insurance		
4.3	Financial literacy programs		

6.3.7. Human Capital and Knowledge Development

Islamic Research and Training Institute (IRTI) undertakes basic and applied research and training to promote the Islamic financial sector. Global Islamic Finance Development Center (GIFDC) of the World Bank also conducts research and training and provides technical assistance and advisory services to different countries to develop Islamic financial institutions and markets. While the IFSB provides some training on its published standards, other areas of Islamic financial infrastructure are not covered.

Table 6.18: Human Capital and Knowledge Development

No.	Institutional Elements	Existing Institutions	Role and Responsibilities
4.1	Research and Development	<ul style="list-style-type: none"> • IRTI • GIFDC 	<ul style="list-style-type: none"> • Promote research & training in Islamic economics & finance • Conduct training, advisory services for development of Islamic finance • Organize conferences/ forums on Islamic economics and finance
4.2	Knowledge/skills on infrastructure institutions	<ul style="list-style-type: none"> • IFSB 	<ul style="list-style-type: none"> • Research and training on Islamic infrastructure institutions

⁶⁶ Neinhaus (2015)

⁶⁷ Najeeb and Mustafa (2016)

6.4. Conclusions

The results from the country case studies and international infrastructure institutions reveal that the financial architecture for Islamic finance is diverse. While in some areas the international standard setting institutions have provided the basic framework for certain infrastructure institutions, in a few others there are gaps. For example, while IFSB and AAOIFI provide guidelines and standards for regulations and accounting standards, there are no international organizations that provide templates for Islamic financial laws that countries can adopt. The existence of different international guidelines and standards for Islamic finance, however, does not mean that these are automatically adopted by different countries. Different factors determine whether a country will adopt the guidelines and standards developed by international standard setting bodies.

As infrastructure institutions by their nature need to be undertaken by governmental bodies, a key factor that determines them is the political will which is reflected in public policies and legal and regulatory systems. For example, Sudan has adopted an Islamic legal system and the whole financial sector is Islamic. Not only are legal and regulatory frameworks appropriate for Islamic finance, the country has also adopted the international accounting and regulatory standards of both AAOIFI and IFSB for the Islamic financial sector respectively. Most other countries where Islamic finance operates have either the common law or civil law regimes and have the conventional financial system dominating the financial sector. The adoption of financial architectural institutions in general and international Islamic standards in particular would require public policy initiatives that change and adjust the existing infrastructure institutions to accommodate Islamic finance. While a few countries have adopted AAOIFI and IFSB standards, most have not. Some countries encourage the use of AAOIFI standards on a voluntary basis.

7. Policy Recommendations

Chapter 6 showed the status of different infrastructural institutions in different countries for Islamic finance. While a few countries have sound and mature financial architecture for the Islamic financial sector, the institutions are weak and underdeveloped in some other countries. In this chapter, the policies that can be undertaken to strengthen the financial architecture for Islamic finance are identified. The policies are presented in line with the architectural elements discussed in previous chapters. It should be noted that the order in which the recommendations are arranged for each of the architectural elements shows the priority in terms of their importance.⁶⁸

7.1. Policies at the National Level

7.1.1. Legal Infrastructure

A key element in the legal infrastructure is to have supporting laws for different Islamic financial sectors. Thus, governments need to come up with supporting Islamic financial laws to give legal foundations for different segments of the Islamic financial industry. The tax laws related to income (profit, withholding), transactions (capital gains and stamp duties) and goods and services (value-added tax) need to be accommodated for tax neutrality and to level the playing field of Islamic and conventional financial sectors.

Table 7.1: Policy Recommendations for Legal Infrastructure

No.	Recommendations	Specific Steps	Implemented by
1.1	Adopt Islamic financial laws	<ul style="list-style-type: none"> Islamic banking law Takaful law Islamic capital markets law 	<ul style="list-style-type: none"> Government (Ministry of Law/ Legal Affairs)
1.2	Adopt Supporting Tax Laws for Islamic Financial sector	<ul style="list-style-type: none"> Change/accommodate tax neutrality issues to level the playing field of Islamic banking and conventional banks Change/accommodate tax neutrality issues for sukuk issuance 	<ul style="list-style-type: none"> Government (Ministry of Finance)
1.3	Appropriate dispute resolution framework	<ul style="list-style-type: none"> Arrangement in civil courts to adjudicate Islamic finance disputes Specific Islamic arbitration centers 	<ul style="list-style-type: none"> Government (Ministry of Law/ Legal Affairs)
1.4	Bankruptcy Framework and Resolution of banks	<ul style="list-style-type: none"> Develop a general Islamic bankruptcy framework for corporate sector Develop specific framework of resolution of Islamic banks 	<ul style="list-style-type: none"> Shariah scholars/board Government (Ministry of Law/ Legal Affairs)

⁶⁸ Note that one of the criteria used to assess the priority of recommendations is the prevalence and frequency with which they affect the Islamic financial sector. For example, for legal infrastructure 'adoption of Islamic finance laws' is given priority as it is necessary for not only establishing new Islamic financial institutions but also governing their operations at all times. An appropriate dispute resolution framework is applicable only when disputes arise.

As civil courts in most of the OIC MCs use national laws to adjudicate disputes, there is a need to have some arrangements where the Islamic financial contacts can be examined according to the principles of Islamic law. This can be done by either having a separate Shariah bench within the civil courts or referring the Shariah issues to an external Shariah board or authority for advice. Alternatively, arbitration centers that use Islamic law to adjudicate cases can be used for disputes arising in the Islamic financial sector. Finally an Islamic bankruptcy legal framework that can deal with insolvencies and resolutions involving the Islamic financial sector is needed to mitigate legal risks.

7.1.2. Regulations and Supervision

As the introduction of Shariah principles changes the nature risks and return of Islamic financial transactions compared to their conventional counterparts, the regulatory treatment of the former would be different compared to the latter. As such, there is a need to come up with a relevant regulatory framework for the Islamic financial sector. In this regard, the regulatory standards developed by IFSB will be relevant. As the Islamic financial sector becomes larger, there should be separate regulatory departments/units to deal with the issues arising in different Islamic financial sectors. To mitigate regulatory arbitrage, the licensing and regulatory requirements of conventional and Islamic banks should be clearly defined and applied.

Table 7.2: Regulations and Supervision

No.	Recommendations	Specific Steps	Implemented by
2.1	Adopt Islamic financial regulations	<ul style="list-style-type: none"> • Adopt regulatory framework for Islamic banks in line with IFSB standards • Adopt regulatory framework for Takaful in line with IFSB standards • Adopt regulatory framework for Islamic capital markets in line with IFSB standards 	<ul style="list-style-type: none"> • Banking sector regulator • Insurance/Takaful sector regulator • Capital markets regulator
2.2	Separate regulatory department dealing with Islamic finance	<ul style="list-style-type: none"> • Establish separate regulatory department dealing with Islamic banks • Establish separate regulatory department dealing with Takaful • Establish separate regulatory department dealing with Islamic capital markets 	<ul style="list-style-type: none"> • Banking sector regulator • Insurance/Takaful sector regulator • Capital markets regulator

7.1.3. Shariah Governance Framework

As Shariah compliance is the key distinguishing feature of Islamic finance, there is a need to have a Shariah governance framework to ensure that the products and operations of Islamic financial institutions do not contradict the principles of the Shariah. One of the key elements of ensuring a sound Shariah governance framework is to make it a legal/regulatory requirement. This can be done either by adding the requirement of Shariah governance at the financial institution level in Islamic financial laws or in regulations. The regulators can come up with specific Shariah governance guidelines that banks are required to follow. Among others, this should include the requirement of Shariah audit to ensure that all the operations of financial institutions are in compliance with Shariah.

Existence of an independent national Shariah body can help harmonize the Shariah rulings and minimize diversity of fatwas that introduces legal and reputational risks. The national Shariah board can either be established by the regulators or by the religious ministry. There can be a separate Central Shariah Board for different financial sectors or one central board that deals with all sectors. One of the roles of the national level Shariah board is to come up with Shariah parameters or standards for different Islamic financial products. This will add to the harmonization of Islamic financial practices within the jurisdiction and also reduce the costs of Shariah governance at the organizational levels.

Table 7.3: Shariah Governance Framework

No.	Recommendations	Specific Steps	Implemented by
3.1	Legal/Regulatory Requirement for Shariah Governance (SG)	<ul style="list-style-type: none"> • Shariah governance framework included in Islamic financial laws • Regulatory framework for SG in Islamic banks • Regulatory framework for SG in Takaful • Regulatory framework for SG in Islamic capital markets 	<ul style="list-style-type: none"> • Government (Ministry of Law/ Legal Affairs) • Banking sector regulator • Insurance/Takaful sector regulator • Capital markets regulator
3.2	Central Shariah Advisory Board (CSAB)	<ul style="list-style-type: none"> • CSAB for Islamic banking sector • CSAB for Takaful sector • CSAB for Islamic capital markets 	<ul style="list-style-type: none"> • Government (Ministry of Religious Affairs) • Banking sector regulator • Insurance/Takaful sector regulator • Capital markets regulator
3.3	Developing Shariah parameters/ standards	<ul style="list-style-type: none"> • Shariah parameters/ standards for Islamic banking sector • Shariah parameters/ standards for Takaful sector • Shariah parameters/ standards for Islamic capital markets 	<ul style="list-style-type: none"> • CSAB for Islamic banking sector • CSAB for Takaful sector • CSAB for Islamic capital markets

7.1.4. Liquidity Infrastructure

The liquidity infrastructure can be strengthened by providing the instruments, markets and the facilities that Islamic financial institutions can tap into in case they need them. This would require developing and issuing Shariah compliant liquidity instruments that Islamic financial institutions can use either to place surplus funds or acquire funds when necessary. These liquidity instruments can be issued either by the government or financial institutions. Note that the government bodies have to come up with Shariah compliant liquid instruments that satisfy conditions of High Quality Liquid Assets of the new Basel III liquidity requirements.

Table 7.4: Liquidity Infrastructure

No.	Recommendations	Specific Steps	Implemented by
4.1	Shariah compliant liquidity instruments	<ul style="list-style-type: none"> • Issue government sponsored Islamic liquidity instruments • Issue private sector sukuk issues 	<ul style="list-style-type: none"> • Government (Ministry of finance) • Central bank • Financial institutions
4.2	Islamic money market	<ul style="list-style-type: none"> • Develop infrastructure for secondary markets for Islamic instruments • Develop a framework for inter-bank money market 	<ul style="list-style-type: none"> • Central bank • Regulator (capital markets) • Financial institutions
4.3	Lender of the last resort	<ul style="list-style-type: none"> • Shariah complaint liquidity facilities for Islamic financial institutions 	<ul style="list-style-type: none"> • Central bank

There is also a need to develop an active money market that would use some of these instruments to meet the short-term liquidity needs in an organized way. This platform can be established by the government in the countries where Islamic finance is in the initial stages of development. Finally, Shariah complaint lender of the last resort would be required so that Islamic financial institutions can benefit from the liquidity facility in case of emergencies.

7.1.5. Information Infrastructure

As some features of Islamic financial transactions require using specific accounting and auditing treatments, there is a need to require Islamic banks to use accounting standards that reflect these. In this regard, countries need to either adopt AAOIFI accounting and auditing standards or introduce changes in the domestic accounting and auditing standards to accommodate features of Islamic financial transactions. There is a need also to come up with disclosure and transparency requirements that are relevant for Islamic finance. Some of these disclosure requirements are identified in AAOIFI standards and the IFSB also has published standards on the topic. One of the key issues that should be disclosed is the Shariah compliance related issues to enhance the confidence of the customers. Not only should the structure of products be disclosed but also the basis of Shariah rulings for them. While the domestic Islamic accounting and disclosure standards need to be developed by the national accounting standards setting board, their implementation would be required by the regulators.

Credit information services and ratings agencies provide relevant information to different stakeholders that can be used to make financial decisions. While the former relates to the clients of financial institutions, the latter provides an assessment of organizations and instruments. However, most of the credit information and rating agencies provide assessments relating to credit worthiness for debt based financing. As Islamic finance emphasizes both debt and equity based financing, the credit information services and rating agencies should be able to provide both perspectives. Thus there is a need to have public and private institutions that provide relevant information on clients, organizations and instruments dealing with the Islamic financial sector.

Table 7.5: Information Infrastructure

No.	Recommendations	Specific Steps	Implemented by
5.1	Accounting and auditing standards	<ul style="list-style-type: none"> • Adopt AAOIFI standards for Islamic financial institutions • Adapt domestic accounting standards to accommodate features of Islamic financial transactions 	<ul style="list-style-type: none"> • Regulators • Domestic Accounting standards boards
5.2	Disclosure and Transparency	<ul style="list-style-type: none"> • Specific disclosure guidelines for Islamic finance sector • Require disclosure of Shariah compliance of operations and products 	<ul style="list-style-type: none"> • Regulators • Domestic Accounting standards boards
5.3	Credit information systems and rating agencies	<ul style="list-style-type: none"> • Establish credit information systems not only for debt but also equity based financing • Rating of Islamic financial institutions and instruments • Rating of Shariah compliance 	<ul style="list-style-type: none"> • Public and private credit information systems • Rating agencies

7.1.6. Consumer Protection & Financial Literacy

A robust consumer protection regime is necessary for the development of a sound financial system. As Islamic financial products confer various rights and obligations to different parties of the contract, the laws and regulations must entail that specific consumers are protected. Among others, information disclosure on the contracts used and their structures should be disclosed to consumers. As many consumers choose Islamic finance due to religious convictions, one of the key issues in protecting consumers of the Islamic financial sector would be to not only ensure Shariah compliance but its full disclosure. A related issue on the demand side is to have financial literacy programs to increase awareness and the level of understanding of Islamic financial transactions. Islamic financial products are new for consumer in most jurisdictions and there is a need to educate the consumers about the features of these products. Other than introducing the Islamic finance concepts in school and college curricula, different stakeholders such as regulators, financial institutions, Islamic finance trade associations can use various methods to disseminate knowledge on Islamic financial products and operations.

A Shariah compliant deposit insurance scheme should be in place to protect appropriate depositors of Islamic banks. There is, however, a need to have clarity on the eligibility and nature of profit-loss sharing investment account holders to have deposit insurance.

Table 7.6: Consumer Protection & Financial Literacy

No.	Recommendations	Specific Steps	Implemented by
6.1	Consumer protection framework for Islamic finance	<ul style="list-style-type: none"> Develop specific legal consumer protection framework for Islamic finance Develop specific regulatory consumer protection framework for Islamic finance 	<ul style="list-style-type: none"> Government Regulators
6.2	Financial literacy programs	<ul style="list-style-type: none"> Develop financial literary literature Disseminate knowledge at different levels Use social media to educate people on Islamic finance 	<ul style="list-style-type: none"> Government (Ministry of education) Regulators Financial institutions Islamic finance trade associations
6.3	Deposit Insurance	<ul style="list-style-type: none"> Develop framework for Islamic deposit insurance Establish Islamic deposit insurance company 	<ul style="list-style-type: none"> Government Regulators

7.1.7. Human Capital and Knowledge Development

A key factor that will determine the future expansion of the Islamic financial sector is to have adequate human capital with the right knowledge and skills to drive the industry forward. At the public level, governments and regulators can take initiatives to establish educational, training and research institutions. One area of that needs focus is policy related research and training including topics on the development of Islamic architectural institutions. At the private level, different actors such as research and training institutions, advisory firms and trade associations can do the same. Universities and academic institutions will play an important role not only in providing education in Islamic finance but also to conduct research that can support the industry.

Table 7.7: Human Capital and Knowledge Development

No.	Recommendations	Specific Steps	Implemented by
7.1	Public level initiatives	<ul style="list-style-type: none"> Establish institutions that provide education and training in Islamic banking and finance Sponsor policy related research and training on Islamic finance including Islamic infrastructure institutions 	<ul style="list-style-type: none"> Governments Regulators/central banks
7.2	Private sector initiatives	<ul style="list-style-type: none"> Provide education and training in Islamic banking and finance Initiatives for developing professional certificates for Islamic financial industry 	<ul style="list-style-type: none"> Private sector institutes and centers for education and research Private sector advisory firms Islamic finance trade associations
7.3	Academic institutions	<ul style="list-style-type: none"> Provide education in Islamic banking and finance Conduct research in Islamic banking and finance Organize conferences and forums to enhance awareness and exchange of ideas 	<ul style="list-style-type: none"> Colleges and universities Research institutions Islamic finance trade associations

7.2. International Policies and Recommendations

Given that the Islamic financial industry is a relatively new industry, many of its architectural institutions are evolving in many countries. The industry can benefit from various international multilateral organizations that have developed standards and models dealing with different aspects of financial architectural institutions. When a country lacks a specific standard or code, a suitable strategy would be to develop it using an international benchmark. Countries can examine these standards and frameworks and adapt them to suit the specific needs of the local economy and financial systems. The roles that different multilateral organizations can play in various Islamic financial architectural aspects are discussed below.

7.2.1. Legal Infrastructure

Table 7.8 shows international institutions that can support the development of legal infrastructure institutions. While the International Islamic Center for Reconciliation and Commercial Arbitration (IICRCA) provides an alternative dispute resolution and reconciliation platform to settle cases applying Islamic law for disputes arising in Islamic financial industry, there are no other international bodies supporting the legal framework. As can be seen in Table 7.8 an international body that can come up with model laws related to Islamic finance would help drive the industry forward. In this regard, there are a few examples in conventional finance that are providing assistance to support a robust legal infrastructure. A good example is the *Law and Policy Reform Program* of the Asian Development Bank which was launched in 1995 to support member countries through technical assistance projects relating to legal and judicial reforms and legal empowerment (ADB 2001 and 2016). Among others, this program publishes knowledge products and provides training related to legal aspects arising in environmental issues. Similarly, the World Bank has developed principles and guidelines for creditor rights and insolvency systems that provide, among others, a legal framework for corporate insolvency (World Bank 2001). Similarly, the United Nations Commission on International Trade Law prepared the UNCITRAL model law on International Commercial Arbitration in 1985 that is used by different national arbitration centers globally.

Table 7.8: Legal Infrastructure and Global Institutions

No.	Recommendations	Existing Institutions	Gaps Need to be filled	Implemented by
1.1	Islamic financial laws		• Model Islamic financial laws	• IDB (Law & Legal Policy Program)
1.2	Supporting Laws for Islamic Financial sector		• Model tax laws dealing with Islamic finance	• IDB (Law & Legal Policy Program)
1.3	Appropriate dispute resolution framework	• IICRCA	• Model law for Islamic financial arbitration	• IDB (Law & Legal Policy Program)
1.4	Bankruptcy Framework and Resolution of banks		• Model Islamic bankruptcy laws	• IDB (Law & Legal Policy Program)

The most appropriate multilateral institution to initiate law and legal policy issues related to Islamic finance would be the Islamic Development Bank. As one of the strategic goals of IDB is

to promote the development of the Islamic financial sector, it can come up with a scheme under which various laws that are relevant to Islamic finance can be developed. Specifically, model laws related to Islamic financial institutions and markets, tax laws (to level the playing field) and bankruptcy laws specific to Islamic finance can be developed.

7.2.2. Regulatory Infrastructure

While the IFSB has published six regulatory standards for Islamic banking sector and two standards for takaful sector, there are none for Islamic capital markets. IOSCO however published *Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products* in 2008 and concluded that most of *IOSCO Objectives and Principles of Securities Regulation* can be applied to Islamic capital markets, but there was a need for disclosure of specific issues arising in Islamic capital markets (SCM 2013).

While there are separate international multilateral organizations for different conventional financial sectors, IFSB is the sole global regulatory standard setting body for Islamic banks, takaful and capital markets. As the Islamic financial industry is expected to grow in the future, there will be a need to develop sound regulatory standards for all sectors in a balanced way. To enable this, one option may be to have separate divisions in IFSB to deal with different financial sectors. Specifically, there may be a need to have divisions for Islamic banking, takaful and Islamic capital markets within IFSB each headed by a Deputy or Assistant Secretary-General.

Table 7.9: Regulatory Infrastructure

No.	Recommendations	Existing Institutions	Gaps Need to be filled	Implemented by
2.1	Islamic financial regulations	<ul style="list-style-type: none"> IFSB 	<ul style="list-style-type: none"> Regulatory standards for Islamic capital markets 	<ul style="list-style-type: none"> IFSB

7.2.3. Shari'ah Governance Framework

AAOIFI and IFSB have published Shariah governance guidelines for the Islamic financial industry. Note that while IFSB Shariah governance guidelines provide a general framework, it does not suggest that one model that can be applied to all countries. It is left to individual countries to determine an appropriate Shariah governance regime. These organisations, however, have not come up with guidelines regarding the role that a national Shariah board should play. As the Islamic financial industry will expand in the future, there is a need to develop guidelines for a central Shariah board that can reduce the diversity of rulings and harmonize practices of the Islamic financial sector within countries. In this regard, examples of where a central Shariah board exists such as Indonesia, Malaysia and Pakistan can be examined.

The Islamic Fiqh Academy (IsFA) has played an important role in issuing key Shariah rulings in economic and financial matters. AAOIFI has also published 54 Shariah standards and four Shariah governance standards. However, as the Islamic financial industry grows there will be a need to coming up with Shariah standards/parameters for a wide range of new financial products. Care needs to be taken that the Shariah rulings from different global institutions are harmonious and consistent with other.

Table 7.10: Shari'ah Governance Framework

No.	Recommendations	Existing Institutions	Gaps Need to be filled	Implemented by
3.1	Legal/Regulatory Requirement for Shariah Governance (SG)	<ul style="list-style-type: none"> • IFSB • AAOIFI 	<ul style="list-style-type: none"> • Role of national Shariah board 	<ul style="list-style-type: none"> • IFSB • AAOIFI
3.3	Developing Shariah parameters/ standards	<ul style="list-style-type: none"> • IsFA • AAOIFI • IIFM 	<ul style="list-style-type: none"> • Standards for a range of new financial products 	<ul style="list-style-type: none"> • IsFA • AAOIFI • IIFM

7.2.4. Liquidity Infrastructure

While IIFM has developed some templates of liquidity management instruments such as Islamic repo, LMC and IILM have come up with specific instruments that Islamic financial institutions can use for their liquidity needs. Note that while IILM has a global reach, LMC has more regional scope. Given the huge demand for liquidity instruments relative to supply, there is a need to develop and issue more Shariah compliant liquidity management products. Furthermore, the introduction of Basel III liquidity requirements would require coming up with Shariah compliant High Quality Liquid Assets (HQLA). In this regards, IIFM can come up with templates and IILM can issue instruments that can satisfy the requirements of HQLA in Islamic banks.

While IFSB has published a Technical Note on Islamic money markets, there are no specific models that are suggested. IFSB and IIFM can play an important role in developing standards and templates for Islamic money markets. Similarly, while IFSB has published a working paper of Shariah compliant LOLR, no guidelines or standards on it exist. Thus, specific models and clear guidelines for Islamic LOLR need to be developed.

There is also a need to develop sound deep secondary markets where international Islamic financial securities and sukuk can be listed, traded and settled efficiently. This would require building the necessary market infrastructures such as Electronic Trading Platforms and a Real-time Electronic Transfer of Funds and Securities Systems (Karim 2015: 230).

Table 7.11: Liquidity Infrastructure

No.	Recommendations	Existing Institutions	Gaps Need to be filled	Implemented by
4.1	Shariah compliant liquidity instruments	<ul style="list-style-type: none"> • IIFM • LMC • IILM 	<ul style="list-style-type: none"> • Meeting the huge demand • Shariah compliant HQLA 	<ul style="list-style-type: none"> • IIFM • LMC • IILM • Other regional entities
4.2	Islamic money market	<ul style="list-style-type: none"> • IFSB 	<ul style="list-style-type: none"> • Models of Islamic money market structures 	<ul style="list-style-type: none"> • IFSB • IIFM
4.3	Lender of the last resort (domestic)	<ul style="list-style-type: none"> • IFSB 	<ul style="list-style-type: none"> • Models of Islamic LOLR structures 	<ul style="list-style-type: none"> • IFSB

7.2.5. Information Infrastructure

AAOIFI has published 27 financial accounting standards, 2 codes of ethics and one guidance note related to accounting and auditing for the Islamic financial sector. Similarly, AAOIFI and IFSB have issued standards related to disclosure and transparency for Islamic financial institutions. IFSB, IOSCO and the Securities Commission Malaysia (SCM) published a book entitled *Disclosure Requirements for Islamic Capital Market Products* in 2013 (SCM 2103). However, there are no specific disclosure guidelines issued by IFSB for takaful and Islamic capital markets sectors. Furthermore, there is a need to have detailed standards related to Shariah compliance disclosures.

IIRA is the only international rating agency providing ratings of Islamic financial institutions, Islamic capital market products and *Shari'ah* Quality Rating (SQR) to assess the status of Shariah compliance in different financial institutions. As the Islamic financial sector becomes global, there is a need to come up with international ratings agencies to provide not only credit ratings of Islamic financial institutions and instruments but also Shariah ratings.

Table 7.12: Information Infrastructure

No.	Recommendations	Existing Institutions	Gaps Need to be filled	Implemented by
5.1	Accounting and auditing standards	<ul style="list-style-type: none"> • AAOIFI 		
5.2	Disclosure and Transparency	<ul style="list-style-type: none"> • AAOIFI • IFSB 	<ul style="list-style-type: none"> • Disclosure guidelines for takaful and Islamic capital markets • Shariah compliance of products 	<ul style="list-style-type: none"> • AAOIFI • IFSB
5.3	Rating agencies	<ul style="list-style-type: none"> • IIRA 	<ul style="list-style-type: none"> • Appropriate models and structures for rating risks in equity based instruments • Appropriate models and structures for rating Shariah compliance 	<ul style="list-style-type: none"> • IIRA • Other international rating agencies.

7.2.6. Consumer Protection & Financial Literacy

While consumer protection principles for the conventional financial sector have been published by the OECD and G20 (2011) and the World Bank (2012), there are no specific guiding principles for the Islamic financial sector. Although the IFSB has issued Guiding Principles on Conduct of Business in 2009, there is a need to come up with specific guidelines that deal with protecting consumers of Islamic financial institutions.

While recognizing that IFSB has published a working paper and IADI (2010) has published a discussion paper on Shariah compliant deposit insurance, no specific models or standards of Islamic deposit insurance have been published. IFSB along with the Islamic Deposit Insurance Group of International Association of Deposit Insurers (IADI) can work together to develop a framework for deposit insurance of the Islamic banking sector. Similarly, no international body has developed any framework for enhancing financial literacy related issues of Islamic finance. Being an association of Islamic financial institutions, CIBAFI can take the initiatives to develop

specific material that can be used for educating the people on Islamic financial principles and practices.

Table 7.13: Consumer Protection & Financial Literacy

No.	Recommendations	Existing Institutions	Gaps Need to be filled	Implemented by
6.1	Consumer protection framework for Islamic finance	<ul style="list-style-type: none"> • IFSB 	<ul style="list-style-type: none"> • Guidelines and models of consumer protection laws 	<ul style="list-style-type: none"> • IFSB
6.2	Deposit Insurance	<ul style="list-style-type: none"> • IFSB • IADI 	<ul style="list-style-type: none"> • Models of Islamic deposit insurance structures 	<ul style="list-style-type: none"> • IFSB • IADI
6.3	Financial literacy programs		<ul style="list-style-type: none"> • Samples of potential material used for Islamic money market structures 	<ul style="list-style-type: none"> • CIBAFI

7.2.7. Human Capital and Knowledge Development

Although many universities are providing education and doing research on Islamic banking and finance, some of the applied research and policy oriented papers needed for the development of the industry can also be carried out by international multilateral organizations. In this regards, IRTI, IDB and World Bank GIFDC can play an important role. Another key area that needs attention is the production of relevant knowledge related to sound infrastructural institutions. While IFSB provides some training on its published standards, there is a need to conduct more research and provide training in other areas of Islamic financial infrastructure. This can be done by IDB and WB through their technical assistance programs.

As the Islamic financial industry expands, there will also be a need to develop professional development programs and certificates. Although there are different initiatives taken in the private sector, there is a need to develop certification programs by international bodies to enhance credibility and acceptance. For example, AAOIFI has professional certificates such as the Certified Shari'a Adviser and Auditor (CSAA) and Certified Islamic Professional Accountant (CIPA). There is a need to come up with different sector specific Islamic financial certification programs such as the Islamic banking professional certificate, takaful professional certificate and Islamic capital markets professional certificates. Being a trade association of Islamic financial institutions, CIBAFI can take the initiative to implement these.

Table 7.14: Human Capital and Knowledge Development

No.	Recommendations	Existing Institutions	Gaps Need to be filled	Implemented by
7.1	Research and Development	<ul style="list-style-type: none"> • IRTI • GIFDC 	<ul style="list-style-type: none"> • Enhance investment in research and development of key strategic areas • Research and training on Islamic architectural institutions 	<ul style="list-style-type: none"> • IDB • IFSB • IRTI • WB(GIFDC)
7.2	Professional development programs and certificates	<ul style="list-style-type: none"> • AAOIFI • CIBAFI 	<ul style="list-style-type: none"> • Professional development programs • Sector specific professional certificates 	<ul style="list-style-type: none"> • AAOIFI • CIBAFI

7.3. Lessons and Conclusions

7.3.1. National Level Infrastructure Institutions

While establishing most of the financial architecture is the prerogative of government level bodies, the case studies show that the development of Islamic financial infrastructural institutions has taken different paths. While in some countries the financial architecture has progressed, in other countries it is relatively underdeveloped. The experience of Pakistan shows the important role financial architecture plays in the development of Islamic finance. Islamic finance was initiated in the 1980s with the publication of a report on interest-free economic system Council of Islamic Ideology (CII). However, as the infrastructure institutions were not established, the implementation of Islamic finance in practice could not be realized as was apparent in the conclusion of the Shariat Appellate Bench of the Supreme Court in 1991 that the system adopted was not Islamic. In 1999, the Appellate Bench declared that certain fundamental changes were needed to make the financial system Islamic. Thereafter, Pakistan took a gradual approach and adopted a dual banking model where Islamic banks operated parallel to their conventional counterparts. The relevant government bodies started to strengthen various architectural institutions for Islamic finance which has resulted in the sound growth of the sector.

There are different factors that determine whether the supporting architectural institutions are developed in any country. The case studies show that the public policy approaches taken to develop Islamic financial architectural institutions in different countries can be broadly classified into three types. First there is the proactive approach where governments have taken initiatives to provide a sound legal and regulatory framework and other infrastructural institutions. In some countries, the intent and interest in developing Islamic finance is reflected in some public policy strategic documents. For example, Malaysia's strategic documents issued by the central bank and securities commission identify the development of Islamic finance segments as key strategic goals. Therefore, relevant public bodies have taken initiatives to develop the elements of the architectural institutions significantly to support the industry. In Oman where Islamic finance is relatively new, supportive political will is reflected in laying down a sound legal and regulatory framework for Islamic finance. As a result, the share of the Islamic banks in the total banking sector in the country has risen close to 4.5% in 3 years, which is similar to Indonesia where Islamic banks have been operating since early 1990s.

Second, in the reactive approach, public bodies initiate infrastructural institutions as a reaction to developments of industry at the ground level. The strategies taken in the reactive approach can be varied. In some countries, the relevant governmental bodies have adjusted laws and regulations and have also developed some of the infrastructural institutions. For example, other than adjusting the laws and regulations, Indonesia has introduced other initiatives such as developing Islamic money market instruments and using the national Shariah Board for product clearance. Other countries have changed some of its laws and regulations but have not been active in developing other infrastructural institutions. In some cases, instead of developing infrastructural institutions themselves, the public bodies have encouraged the stakeholders of the Islamic financial sector to establish certain supporting infrastructural institutions. For example, in Bangladesh the central Shariah board and inter-bank money market have been established at the initiatives of Islamic banks. Similarly, Participation Bank Association of Turkey plays an important role in framing necessary policies and strategies related to the development of Islamic banking in the country.

The third group of countries are those where the governmental bodies have not taken initiatives to either accommodate the laws and regulations or develop other infrastructure institutions. The legal and regulatory environment for Islamic financial institutions is same as their conventional counterparts. Countries in this group include Saudi Arabia and Senegal.

The lack of attention to provide infrastructural institutions for Islamic finance in some countries such as Senegal may partly be because the size of the industry is relatively small. However, lack of supportive initiatives to develop the financial architecture due to small size can create a conundrum as further growth of Islamic finance can be hampered due to deficient infrastructural institutions. The case of Oman shows that a supportive legal and regulatory system can help promote the growth of Islamic finance. The impact of a lack of infrastructural institutions can be more serious in countries where Islamic finance has grown significantly due to demand side factors. In some countries such as Saudi Arabia and Bangladesh, Islamic finance is demand driven and the sector has grown to significant levels that make them systematically important. In these countries, the development of infrastructural institutions to support and promote the development of a sound and stable financial sector is essential.

Even if there is political will to support the industry, one of the key constraints that many countries face is the lack of knowledge base and human capital to support the expanding Islamic financial sector at different levels. The growth of the industry would require enhancing the knowledge base not only on the supply and demand sides but also at the public institutional level. As Islamic finance is relatively new and combines finance, laws, regulations and Shariah principles, professionals with appropriate knowledge are relatively scarce. Specifically, the development of Islamic financial architecture would require personnel with knowledge and skills related to various Islamic infrastructure institutions. For example, there is a need for staff at the regulatory level who are well versed with the risks and stability issues related to the Islamic financial sector. Similarly, people with appropriate knowledge on Shariah and finance would be needed for central Shariah boards and developing liquidity instruments. The consumer protection and financial literacy aspects of Islamic finance require an understanding of the rights and obligations of the different stakeholders in Islamic financial contracts. While the case studies show that many countries have initiated educational programs in Islamic finance, professionals with knowledge and skills at the institutional levels are still lacking.

Other than Sudan which has an Islamic legal system and financial sector, Malaysia appears to have taken proactive initiatives to strengthen the Islamic financial infrastructure institutions at different levels. Starting with including the development of Islamic finance in its national strategic documents, initiatives have been taken to provide a supportive infrastructure for the sector. Not only has Malaysia enacted extensive laws and a separate regulatory department for Islamic finance, it has also established a robust Shariah governance regime and liquidity infrastructure. Furthermore, the country has adapted the information infrastructure and invested in human capital development to promote Islamic finance industry. Though, OIC MCs have different legal systems and regimes and cannot apply the Malaysian model completely, the example highlights the key issues that need to be dealt with for the development of the Islamic financial sector in the future.

7.3.2. International Level Infrastructure Institutions

While the role of different existing infrastructural bodies has been identified above, this section discusses the need for newer institutions that may be necessary to support the sound growth of Islamic finance in the future. To have a perspective of the gaps in the global infrastructural institutions for Islamic finance, Table 7.15 identifies the different initiatives that support the conventional financial sector and then presents the corresponding institutions that need to be present to strengthen the international infrastructure for Islamic finance.

As the Islamic financial sector is growing in many countries and will become systematically important in the future, there may be a need for policies that will reduce systemic risks and bring about stability in OIC MCs. One key policy issue relates to the implementation of international financial standards developed by different global standard setting bodies. Some organizations such as World Bank and IMF that encourage the adoption of international standards under the Financial Sector Assessment Program (FSAP) and Reports on Standards and Codes (ROSC) for the conventional financial sector. More recently, the FSB was established after the GFC in 2009 to bring together policy makers and regulators from different countries to promote 'financial stability by coordinating the development of regulatory, supervisory and other financial sector policies'.⁶⁹ FSB assesses the vulnerabilities that can lead to global systemic risk, develops policy responses to address the weaknesses, and oversees and monitors the implementation of policy recommendations. Unlike these organizations that encourage the adoption of international standards for the conventional financial sector, no such initiatives are taken for Islamic finance.

Given that different international standard setting bodies related to Islamic finance are operating without coordination, an organization similar to FSB may be a suitable response to address the infrastructure related issues for the Islamic financial sector. The role of the Stability Board for Islamic Finance (SBIF) would be to enhance the global stability and development of a sound Islamic financial sector by coming up with a framework of establishing Islamic Financial Sector Assessment Program (IFSAP) and relevant Standards and Codes applicable to Islamic financial sector. SBIF will coordinate not only the implementation of existing standards of IFSB and AAOIFI but also contribute to filling the gaps in other architectural elements such as the legal and Shariah governance frameworks for the Islamic financial sector globally. As the body would engage key policy holders from different countries, the suggested SBIF can either be initiated by OIC under the realm of COMCEC or by D-8 countries.

For countries in which the Islamic financial industry forms a significant part of the overall financial sector (or is wholly Islamic such as in Sudan), there may be a need to have international Shariah compliant LOLR facilities. However, at present there are no such facilities available. While the Islamic Development Bank exists as an alternative to Shariah compliant developmental financial institutions, no Shariah compliant organization similar to IMF exist that can provide liquidity in times of need. As the Islamic financial industry grows, there may be a need to establish an entity similar to IMF that can provide Shariah compliant liquidity in times of need. To start with, different international Islamic infrastructure institutions related to Islamic financial industry and liquidity management (IDB, IFSB, IIFM, IILM and LMC) can

⁶⁹ <http://www.fsb.org/what-we-do/>

coordinate to establish an Islamic Monetary Fund (IsMF) that can perform the function. The role of IsFM will be to either provide Shariah compliant liquidity or coordinate arranging liquidity from other central banks by using swap arrangements.

As the Islamic financial sector is evolving, application of the standards and guidelines to strengthen the financial architecture would require improving the knowledge and skills of the personnel working in different infrastructural institutions at the national levels. The case studies indicate that there is lack of understanding of Islamic finance related issues among the infrastructure related institutions such as regulatory bodies. SBIF in coordination with IDB have created technical assistance programs to provide education and training to relevant staff and employees of different infrastructural institutions.

Table 7.15: Suggested New International Infrastructure Institutions and Initiatives

Infrastructure Institutions	Institutions for Conventional Finance	Suggested Institutions and Initiatives for Islamic Finance
Legal Infrastructure	UNCITRAL, World Bank, ADB (Law & Policy Reform Program)	Create a new body/entity Stability Board for Islamic Finance SBIF (either by OIC/COMCEC or D-8) IDB can initiate Islamic Law & Policy Program
Regulation & Supervision Framework	BSBC, IOSCO, IAIS	Strengthen IFSB (have three Assistant Secretary Generals for Banking, Takaful and Capital Markets)
Shariah Governance Regimes	N.A.	SBIF coordinate the Shariah issues with AAOIFI, IsFA, IFSB and IIFM
Liquidity Infrastructure	IMF	Establish IsMF to develop liquidity management framework in coordination with IDB IFSB, IIFM, IILM and LMC
Information Infrastructure & Transparency	IFSR, World Bank (FSAP), FSB	SBIF coordinate accounting and auditing issues with AAOIFI, IFSB and IIRA
Consumer Protection Architecture	IADI, OECD, World Bank	SBIF coordinate accounting and auditing issues with IFSB, CIBAFI, IADI
Human Capital & Knowledge Development	N.A.	SBIF and IDB can coordinate with AAOIFI, CIBAFI, GIFDC, IDB, IFSB SBIF and IsMF and develop technical assistance programs to enhance knowledge and skills related to Islamic financial architecture

8. Summary of the Findings and Conclusion

This concluding chapter summarises the key findings of different Islamic financial architectural elements from case studies and highlights the steps that need to be taken by different stakeholders to further strengthen the architectural institutions. A summary of the statuses of the Islamic architectural institutions at the national levels are presented and then the role that various international organizations can play to strengthen these institutions are discussed. The chapter ends by highlighting some issues related to the constraints and prospects of Islamic finance in global financial centers.

8.1. National Financial Architecture: Status and Responsible Stakeholders

The case studies show that countries are at different levels of development of Islamic financial architecture. Table 8.1 shows the overall average statuses of different infrastructure institutions for the case studies. While most of the architectural elements are in the 'developing' stage, information infrastructure and consumer protection infrastructure are 'underdeveloped'. The results from the legal infrastructure for Islamic finance indicate that there is room to strengthen legal institutions. These can be done by implementing supporting Islamic financial laws for the banking, takaful and Islamic capital markets; tax laws that level the playing field between Islamic finance and conventional finance; and bankruptcy laws that take into consideration the special features of the Shariah. There is also a need to accommodate adjudication of disputes arising in Islamic finance either in civil courts or arbitration centers. One initiative in this regard is to attempt to harmonize the civil laws of the country with Shariah principles governing Islamic finance. As enacting laws and setting up legal institutions are the prerogative of states, governments need to come up with the supporting legal framework for the Islamic financial industry.

As financial sectors are one of the most regulated industries, there is a need to have an accommodating regulatory framework for the Islamic financial industry. The regulatory authorities need to understand the nature of the risks arising in the Islamic financial industry to develop an appropriate regulatory framework. This may require not only appropriate regulations for all sectors of the Islamic financial industry but also separate departments/units in regulatory bodies dealing with the Islamic financial sectors. The key components of a sound Shariah governance regime are existence of a national Shariah body, a framework for Shariah boards at the financial institutions, and Shariah standards/parameters for the industry. While, some of these features can be included in Islamic financial laws, the regulators play a key role in setting up this framework. The national Shariah board will be responsible for issuing the Shariah standards/parameters and promoting the harmonization of practices by ensuring Shariah compliance of the contracts used in the industry.

A robust liquidity infrastructure constitutes appropriate instruments, efficient and liquid financial markets and access to LOLR funds from central banks. Islamic financial institutions need short-term tradable Shariah compliant securities to manage their liquidity needs and risks. There is not only a scarcity of Shariah compliant liquid instruments but most jurisdictions lack deep and efficient and deep Islamic financial markets. While the central bank and regulatory authorities can help develop the infrastructure for financial markets, the liquidity instruments can be supplied by both public and private entities. Arrangements for Shariah compliant LOLR facilities for Islamic banks have to be put in place by the central banks.

Table 8.1: Status and Responsible Stakeholders at the National Level

Infrastructure Institutions	Overall Averages	Overall Ranking	Responsible Stakeholders
Legal Infrastructure	57.5	Developing	Government
Regulation & Supervision Framework	48.6	Underdeveloped	Regulators
Shariah Governance Regimes	47.3	Underdeveloped	Government, regulators, national Shariah board
Liquidity Infrastructure	61.1	Developing	Government, regulators, central bank, financial institutions
Information Infrastructure & Transparency	50.0	Developing	Regulators, domestic accounting standards body, rating agencies
Consumer Protection Architecture	41.6	Underdeveloped	Government, regulators, financial institutions, trade associations
Human Capital & Knowledge Development	69.4	Developing	Government, private sector, universities and academic institutions

To properly reflect the transactions and operations of Islamic financial institutions, countries can opt for using either AAOIFI accounting standards or domestic accounting standards that are adapted for Islamic finance. Though the domestic accounting body has the responsibility to develop the standards, the decision of requiring Islamic financial institutions to use Islamic accounting standards has to come from the regulators. Other than the credit ratings provided by conventional rating agencies for debt based transactions, other types of assessments may be required for the Islamic financial sector. These include Shariah compliance ratings and providing assessments for equity modes of financing. Accomplishing these would require establishing processes that require knowledge and skills that are different from those used to assess debt based transactions.

The key items identified in consumer protection architecture include laws/regulation to protect consumers, deposit insurance and financial literacy programs. Table 8.1 indicates that this architectural component to be the weakest for the Islamic financial sector in the countries that were examined. One of the key issues in protecting consumers of Islamic financial sector is to ensure Shariah compliance and its disclosure as many consumers choose Islamic finance due to religious convictions. While instituting appropriate laws and regulations to protect consumers and deposit insurance have to be done by the government and regulators, improving financial literacy will require efforts at different levels. Building the content on Islamic financial principles and products and its dissemination can be done introducing these in the school/college curricula by the Ministry of Education and also by regulators, Islamic financial institutions and trade associations.

Human capital and knowledge development appear to be the strongest element of the Islamic financial architecture. However, as the industry is expected to grow, there will be increasing demand for personnel with the appropriate knowledge and skills, particularly in countries where the industry is relatively new. In this regards, the public and private sector entities along with academic institutions and universities can contribute providing training and building the knowledge base for the future growth of the industry.

Given the above, the six most important policy recommendations that will strengthen the Islamic financial architecture at the national level are as follows:

1. Adopt Islamic financial laws
2. Adopt Islamic financial regulations
3. Provide a legal and regulatory framework for Shariah governance
4. Shariah compliant liquidity instruments
5. Introduce accounting and auditing standards for the Islamic financial sector
6. Establish a consumer protection framework for Islamic finance.

8.2. International Infrastructure Institutions: Status and Responsible Stakeholders

Development of standards and guidelines by international multilateral institutions can help promote sound architectural institutions. The Islamic financial industry can benefit from input of various international multilateral organizations that develop standards dealing with different aspects of financial architectural institutions. As these standards are developed with consultations with different stakeholders at the global level, they reflect the culmination of knowledge that is based on high level expertise and collective efforts. Countries with underdeveloped infrastructures can benefit by using the framework provided by international benchmarks to develop institutions that can support the Islamic financial industry.

The study suggests the establishment of a Stability Board for Islamic Finance (SBIF) to enhance the global stability and development of a sound Islamic financial sector. Among others, SBIF can come up with a framework of establishing Islamic Financial Sector Assessment Program (IFSAP) and relevant Standards and Codes applicable to Islamic financial sector. SBIF will coordinate not only the implementation of existing standards of IFSB and AAOIFI but also contribute to filling the gaps in other architectural elements such as the legal and Shariah governance frameworks for the Islamic financial sector globally. As the body would engage key policy holders from different countries, the suggested SBIF can either be initiated by OIC under the realm of COMCEC or by D-8 countries.

The gaps in legal infrastructure in terms of laws related to Islamic finance will be easier to fill if there are model laws that the countries can refer to. Specifically, there is a need to develop templates of Islamic banking, takaful, Islamic capital markets and bankruptcy laws and identify issues that need to be tackled for tax neutrality purposes. Currently there are no global initiatives that deal with legal matters. There is a need for a global organization that can develop and publish legal documents and templates to help the development of the legal infrastructure for Islamic finance in OIC MCs. This initiative is similar to the *Law and Policy Reform Program* of the Asian Development Bank and can be best performed by IDB. Other than coming up with templates for Islamic financial laws, one of the issues that this initiative can do is to come up with frameworks for harmonizing the national laws with Shariah principles governing Islamic finance in both civil law and common law countries.

IFSB has developed many regulatory standards for the Islamic financial industry. However, the published standards and guidelines for different sectors have not been even. For example, while IFSB published the Core Principles for Islamic Finance Regulations for the Islamic banking sector, corresponding Core Principles for the *takaful* and Islamic capital markets need yet to be published. IFSB can continue its collaboration with international organizations such as IAIS and IOSCO to develop different standards and guidelines for the *takaful* and Islamic capital markets sectors. As the Islamic financial industry is expected to grow in the future, there may be a need to strengthen the institutional capacity of IFSB. One way to do this is to

have separate divisions within the IFSB dealing with issues related to Islamic banking, takaful and Islamic capital market segments. Both AAOIFI and IFSB have published Shariah governance standards for Islamic financial institutions. However, there are no guidelines for a national Shariah board. Given that national Shariah boards can contribute to harmonization of practice and reduce Shariah compliance risks within jurisdictions, there is a need to come up with a framework for it. Furthermore, the work on developing Shariah standards, parameters and templates for Islamic financial products by AAOIFI, IsFA and IIFM need to continue to enhance cross-border and international transactions by reducing legal and Shariah compliance risks.

Though the sukuk market is growing, its size is still small in terms of global financial markets. Globally the secondary markets for sukuk in most countries are shallow making them illiquid. Although LMC and IILM are making available tradable *sukuk* catering to the liquidity needs of Islamic financial institutions, the supply of instruments that fulfil the Basel III liquidity requirements is small relative to the demand. Furthermore, IFSB and IIFM can develop guidelines and templates to strengthen money markets, secondary markets for Islamic securities and LOLR facilities for Islamic banks. Furthermore, there is a need to establish an Islamic Monetary Fund (IsMF) that can either provide Shariah compliant liquidity at the global level or coordinate arranging liquidity from other central banks by using swap arrangements.

There is significant progress made in developing accounting and auditing standards by AAOIFI. Furthermore, AAOIFI and IFSB has also published disclosure guidelines for the banking and takaful sectors. However, there is a need to develop detailed disclosure guidelines for Islamic capital markets and Shariah compliance of products and securities. Ratings agencies that can assess Shariah compliance and risks in equity based instruments would further strengthen the information infrastructure for the industry.

Table 8.2: Status and Responsible Stakeholders and the International Level

Infrastructure Institutions	Gaps	Suggested Institutions and Initiatives for Islamic Finance
Legal Infrastructure	Develop model Islamic financial, tax and bankruptcy laws	Create a new body/entity Stability Board for SBIF (either by OIC/COMCEC or D-8) IDB can initiate Islamic Law & Policy Program
Regulation & Supervision Framework	Strengthen existing institutions and encourage implementation of International standards.	Strengthen IFSB (have three Assistant Secretary Generals for Banking, Takaful and Capital Markets)
Shariah Governance Regimes	Strengthen existing institutions and encourage implementation of International standards.	SBIF coordinate the Shariah issues with AAOIFI, IsFA, IFSB and IIFM
Liquidity Infrastructure	Strengthen existing institutions	Establish IsMF to develop liquidity management framework in coordination with IDB IFSB, IIFM, IILM and LMC
Information Infrastructure & Transparency	Strengthen existing institutions and encourage implementation of International standards.	SBIF coordinate accounting and auditing issues with AAOIFI, IFSB and IIRA
Consumer Protection Architecture	Create new and strengthen existing institutions	SBIF coordinate accounting and auditing issues with IFSB, CIBAFI, IADI
Human Capital & Knowledge Development	Create new and strengthen existing institutions	SBIF and IDB can coordinate with AAOIFI, CIBAFI, GIFDC, IDB, IFSB SBIF and IsMF and develop technical assistance programs to enhance knowledge and skills related to Islamic financial architecture

Consumer protection has received renewed interest after the GFC and also needs to be strengthened for Islamic finance. There is a need to develop consumer protection guidelines that cater to the specific features of the Islamic financial sector and also come up with a framework for financial literacy programs. SBIF can coordinate with IFSB for developing guidelines on consumer protection and with CIBAFI to develop programs for financial literacy. To protect the Islamic banking depositors during crises would also require appropriate models for deposit insurance. SBIF and IFSB can collaborate with IADI to initiate this project.

Various multilateral organizations such as IRTI, IDB and World Bank GIFDC are involved in research that can promote the development of the Islamic financial sector. These organizations can further contribute to the development of the industry by sponsoring applied and policy oriented research. In particular, there is scarcity of resources in the Francophone African countries and more should be made available to countries both in terms of education and training. With the growth of the industry, the need for credible certification programs for Islamic finance will grow. International industry based organizations such as AAOIFI and CIBAFI can take initiatives to develop internationally recognizable certification programs to increase the knowledge and skills of professionals working in the industry. There is also a need to invest in research and provide training in different areas related to Islamic architectural institutions. While IFSB organizes workshops to familiarize others with their published standards and guidelines, multilateral organizations such as SBIF, IDB and WB can also cover other infrastructural institutions through their technical assistance programs.

8.3. Islamic Finance in Global Financial Centers

The experience of the development of Islamic finance in global financial centers is varied across jurisdictions and sectors. The key determinants of the status of Islamic financial sectors in these centers are the levels of demand on the one hand and the strategic vision to support the industry on the other hand. On the demand side, two types of markets can be identified: domestic and international. Industries such as Islamic retail banking and takaful sectors catering to the needs of domestic clients would, therefore, be limited to countries that have significant Muslim minorities. These sectors would, however, develop in these countries if there is institutional support from governments. The United Kingdom and Singapore fall in this category where both, Islamic retail banking and takaful, have been initiated. While Germany has a relatively large Muslim minority group, no takaful company exists and Islamic retail banking was initiated there recently. This is partly because the government and regulators have not shown strategic interest in the development of Islamic finance.

The international market segment would entail retakaful, wholesale banking and provision of capital market products such as funds and sukuk. While reinsurance companies based in Singapore are offering retakaful services, German companies are offering these services from their overseas offices based in Muslim countries. The United Kingdom and Singapore have also taken initiatives to encourage the development of wholesale banking markets to cater to the needs of Muslims for wealth management. With the exception of Germany, the key focus of remaining global financial centers that were studied has been the capital markets segment. Governments in these countries have promoted the sector, sometimes by accommodating laws and regulations to attract globally mobile Islamic financial businesses.

Table 8.3: Summary Status of Activities in Global Financial Centres

Activities	UK	Germany	Luxembourg	Singapore	Hong Kong
Retail Banking	Yes	Yes	No	Yes	No
Wholesale Banking	Yes	No	No	Yes	No
Takaful/Retakaful	Yes	No	No	Yes	No
Funds	Yes	No	Yes	Yes	Yes
Sukuk	Yes	No	Yes	Yes	Yes
Education/Training Programmes	Yes	Yes	Yes	Yes	No

8.4. Concluding Remarks

A financial system performs certain core functions in the economy that contribute to growth and development. The future growth of Islamic finance will depend on two key interrelated factors: the levels of demand and the capabilities of financial sector satisfy the demands of different stakeholders. Given that the financial sector is complex and one of the most regulated industries, the ability of the financial sector to provide financial services will partly depend on supporting infrastructural institutions. Appropriate infrastructural institutions are needed to reduce the risks and vulnerabilities that can potentially lead to harmful and costly economic downturns. Compliance with the Shari'ah introduces some unique risks in Islamic financial institutions that may need specific attention. Supporting architectural institutions will become important for the future growth and expansion of the Islamic financial sectors in the future.

As establishing the financial architecture is the prerogative of state institutions, the case studies show that financial architectural environment under which Islamic financial sector operates can be distinguished as facilitative and market driven. In the former, the government and public bodies take an active role in providing supportive infrastructure framework. In countries that do not have supportive legal and regulatory environments, the industry is market driven and has to adjust its operations to laws and regulations. This not only affects the type of products that the Islamic financial sector can provide but also introduces legal risks and limits the growth of the industry. At the national level, the governments can introduce supportive infrastructural institutions.

Moving forward, this study has identified some of the financial architectural elements that need to be strengthened for the development of the Islamic financial industry. While the study has identified the architectural elements that need to be strengthened, their development would require in-depth work to come up with appropriate detailed solutions and models. Different international Islamic infrastructure organizations can play a supporting role in this regard by providing standards, guidelines, principles and templates that different countries can use. These organizations can also collaborate with their conventional counterparts to further enhance cooperation and provide the necessary tools for the sound and robust growth of Islamic finance globally. Although these institutions have published various standards and principles, their adoption by OIC MCs will depend on relevant public authorities in general and regulators in particular.

The future growth of the Islamic financial sector will also depend on the demand for its products and services. Significant parts of the growth in demand will come from Muslims who opt for Islamic finance due to religious reasons. For this captive market, mitigating Shariah compliance and reputational risks is important for further expansion in the future. Islamic

finance can also provide alternative options/sources of ethical finance to non-Muslims and wider markets, both at the domestic and international levels. However, tapping into this market would require not only providing the products and services efficiently but also showing and persuading the general public of the social and ethical orientations and practices of Islamic finance.

Many studies, including this one, have considered issues related to the supply side of the Islamic financial industry. Studies examining issues on the demand side of Islamic finance, however, are scant. There is a need to undertake an extensive global study investigating different demand side issues of the industry. The issues that can be explored include, among others, attitudes, preferences, perceptions, satisfaction and knowledge levels of Islamic finance of depositors and customers from different parts of the world. The demand side information is vital as it will reveal the aspirations and expectations of the key stakeholders that not only use Islamic financial services but also provide the bulk of the funds to the industry.

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Chapter 1

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