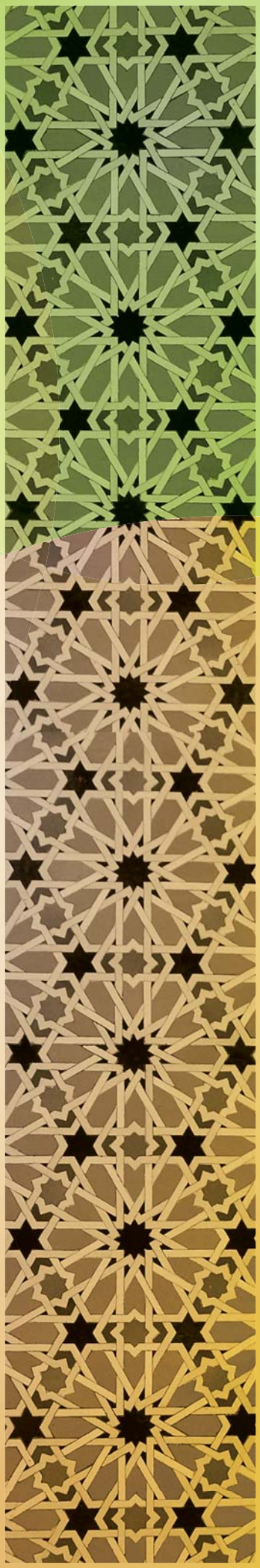
Islamic Finance *news*



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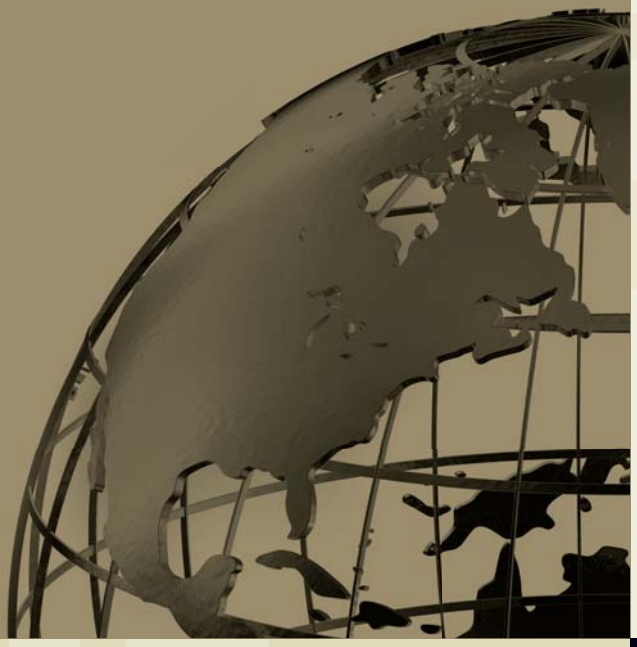

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Islamic Finance *news* team

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Suite C, Level 10 Bangunan Angkasa Raya,
Jalan Ampang, 50450 Kuala Lumpur,
Malaysia
Tel: +603 2143 8100
Fax: +603 2141 5033

EDITORIAL TEAM

Managing Editor Frances O'Sullivan
Frances.OSullivan@RedMoneyGroup.com

Editor Nora Salim
Nora.Salim@RedMoneyGroup.com

Deputy Editor Nazneen Abdul Halim
Nazneen.Halim@RedMoneyGroup.com

Features Editor Shabnam Mokhtar
Shabnam.Mokhtar@RedMoneyGroup.com

Correspondents Kamal Bairamov, Seelan Sakran
Shirene Shan

Forum Manager Christina Morgan
Christina.Morgan@RedMoneyGroup.com

Production Manager Hasnani Aspari
Hasnani.Aspari@RedMoneyGroup.com

SALES TEAM

New Business Manager Charles Philip
Charles.Philip@RedMoneyGroup.com
Tel: +603 2143 8100 x 13

Subscriptions Manager Musfaizal Bin Mustafa
Musfaizal.Mustafa@RedMoneyGroup.com
Tel: +603 2141 8100 x 24

MARKETING TEAM

Marketing Manager Deepa Kaliperumal
Deepa.Kaliperumal@RedMoneyGroup.com

Assistant Dhana Dorasamy
Dhana@RedMoneyGroup.com

Associate Publisher Geraldine Chan
Geraldine.Chan@RedMoneyGroup.com
Tel: +603 2141 6024

Financial Controller Faizah Hassan
Faizah.Hassan@RedMoneyGroup.com

Managing Director Andrew Tebbutt
Andrew.Tebbutt@RedMoneyGroup.com
Tel: +603 2141 6022

Managing Director & Publisher Andrew Morgan
Andrew.Morgan@RedMoneyGroup.com
Tel: +603 2141 6020

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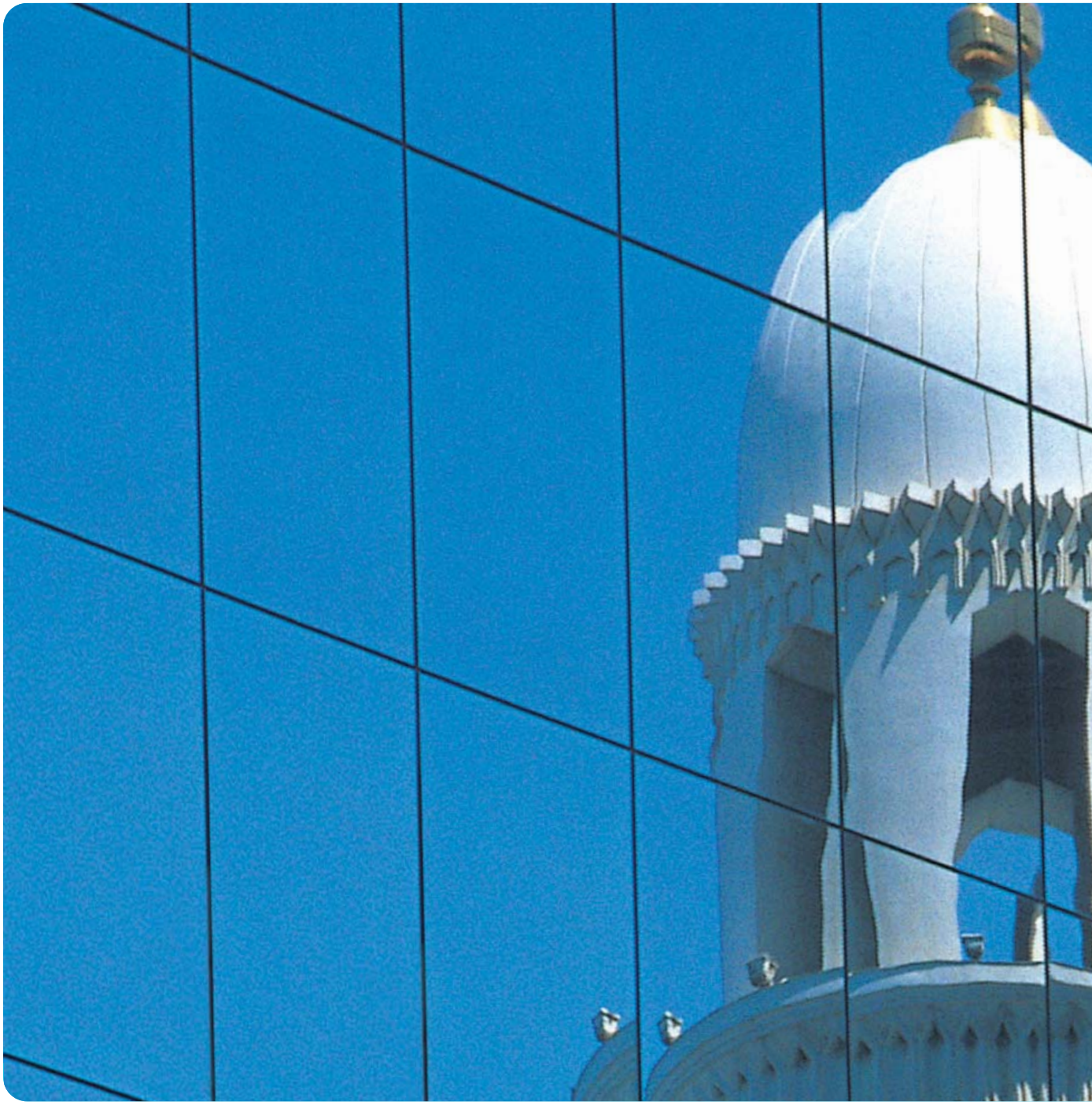

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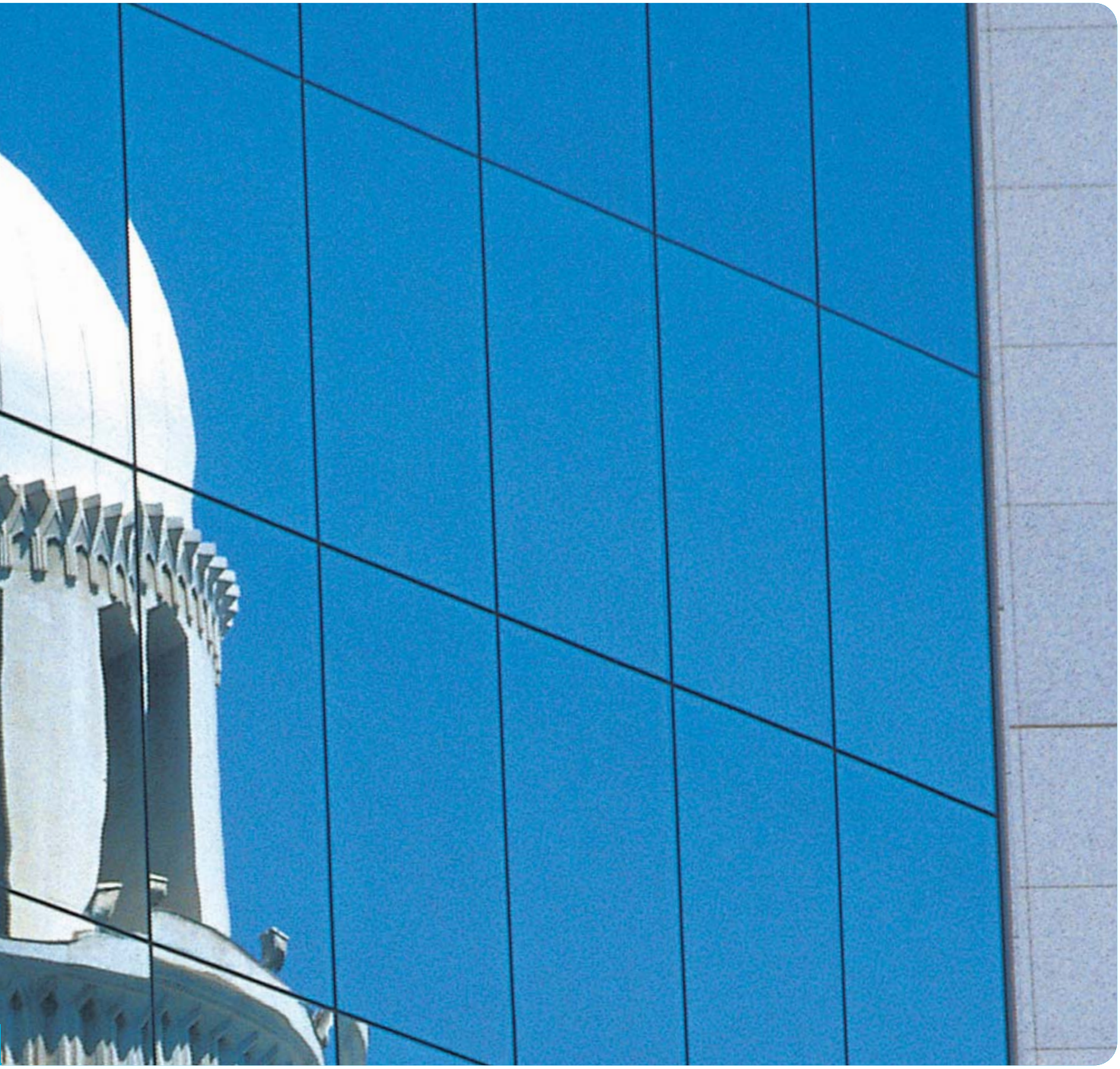

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New Islamic Finance Opportunities in Bahrain

By Shabnam Mokhtar

Bahrain has a long history in the Islamic banking and finance industry. The first Islamic commercial bank in the kingdom, Bahrain Islamic Bank (BIB), was established in 1979. The growth of the industry was slow during the initial years – there were only five Islamic banks and one offshore banking unit by 1994 – however, rising oil prices after the Gulf war acted as a growth stimulator as demand for Islamic products increased due to excess liquidity. As at April 2007 the market had grown to incorporate 27 Islamic banks and 13 Takaful operators in Bahrain. This represents the largest concentration of Islamic banks in the Middle East. Among the prominent players now operating in Bahrain are BNP Paribas, Citi Islamic Investment Bank, ABC Islamic, Al-Baraka Islamic Bank and UBS.

WHY BAHRAIN?

What factors have facilitated Bahrain's emergence as the Islamic financial center of the region? The three most renowned reasons are the role of the Central Bank, the country's strategic location and the existence of supporting institutions in Bahrain. Central Bank of Bahrain (CBB), formerly known as the Bahrain Monetary Agency (BMA), has played a pioneering role in regulating and marketing the industry. CBB was the first to allow the Islamic window concept, where conventional banks are allowed to carry on Islamic banking business using their existing infrastructure. It was also the first country to develop and implement regulations specific to the Islamic banking industry – the Prudential Information and Regulatory Framework (PIRI) in 2001, followed by a comprehensive regulatory framework for Takaful and re-Takaful in 2005.

CBB also pioneered Sukuk issuance for the liquidity management of Islamic banks in 2001 via its Salam and Ijarah Sukuk. In addition, CBB also executed an MOU with Tokyo Commodity Exchange (TOCOM) in 2005 to enable financial institutions, brokers and other players in Bahrain to carry out transactions on TOCOM using Shariah compliant instruments. As a result of CBB's active management, the total assets of Islamic banks in Bahrain grew from US$1.9 billion in year 2000 to US$12.1 billion by March 2007 – an astonishing growth of over 500%. The market share of Islamic banks grew from 1.8% of total banking assets in 2000 to 6.3% in March 2007.

Sohail Tohami, the assistant vice-president of United International Bank (UIB), a wholesale Islamic bank that started operations in September 2006, shared its reason for choosing Bahrain. "We selected Bahrain as our operating center due to the flexibility and potential growth seen in Bahrain's financial sector. CBB is one of the best regulators in the GCC and the region. Bahrain also offers a healthy and competitive environment, and there exists a high demand for Islamic banking and finance among investors." Besides that, Sharifah Baker Ali, a corporate finance manager from Eskan Bank who has formerly worked with Aseambankers in Malaysia, highlighted another active role played by CBB in promoting Islamic banking. "There is ample liquidity in this region and setting up a banking business here is highly encouraged by the Central Bank of Bahrain. The liquidity can support banking transactions in general and Islamic banking activities in specific. In addition, Bahrain is a liberal country and encourages the flow of business. Women are allowed to work and it already has a large expatriate community living in it. Doing business here is pleasant," she elucidated.

The second ingredient in Bahrain's success is its strategic location. It is in the heart of the Middle East region, giving it easy access not only to other countries in the region, but also to European countries. "It is easy to operate from here and do business in other countries like the UAE, Kuwait and Qatar to name a few. This is why Bahrain has been a leading financial center all along," said Agnel Pereira, operations director of First Leasing Bank, an investment bank licensee currently focusing on leasing activity that plans to later expand into real estate operations. Related to its location, Bahrain also has the advantage of closer working hours with European countries. Raed Mirza Abdulla, superintendent of wholesale Islamic bank supervision at CBB highlighted: "The time difference between Bahrain and the European countries is not as wide as other GCC countries. This gives it an extra common working hour to make deals happen."

> **"CBB was the first central bank to make AAOIFI standards mandatory for all players, and other countries later followed"**

Last but not least, the existence of supporting organizations has complemented Bahrain's Islamic finance landscape. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in the early 1990s to devise accounting and Shariah standards for Islamic financial institutions. These standards are important to promote convergence in the Islamic finance industry, thus facilitating comparison and regulation of the industry. CBB was the first Central Bank to make AAOIFI standards mandatory for all players, and other countries later followed. The Liquidity Management Center (LMC) was developed in 2002 as an intermediary agency to underwrite Islamic financial trading. Its aim was to create an active secondary market for treasury management of Islamic banks. LMC also arranged a US$150 million Sukuk for the Bahrain Financial Harbor project and a US$120 million Durrat Al-Bahrain project.

Bahrain also encompasses two bodies supporting the growth of the Islamic capital market – the International Islamic Financial Market (IIFM) founded in 2002 and the Islamic International Rating Agency (IIRA) in 2005. IIFM was re-launched in 2006 with the aim of developing the Islamic primary and secondary market via various projects. IIFM has recently worked with international organizations like the International Capital Market Association (ICMA) and the International Swap and Derivatives Association (ISDA) to explore means to enhance growth in the Islamic capital market. IIRA, with its rating of Takaful and Islamic financial institutions, in both the credit and Shariah quality rating, aims to facilitate more Sukuk issuance that will help the industry to arrive at the critical mass needed to encourage secondary market trading. Bahrain also pioneered the launch of the first Islamic bond index – the Dow Jones Citigroup

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New Islamic Finance Opportunities in Bahrain (continued...)

Sukuk Index Strategy – a joint effort with the CBB, Dow Jones Indexes and Citigroup Corporate and Investment Banking. All these developments attest to Bahrain's focused endeavor to develop a wholesome Islamic financial system comprising not only the banking system but also the money market and capital market system.

Rene Kersenti, the vice-chairman of ICMA, shared his opinion regarding the developments in Bahrain. "ICMA welcomes efforts that promote the development of Islamic finance as an option available to market participants. We have not been involved in the domestic legislative and regulatory policies of the government of Bahrain as that is not within our remit. However, the government's support for multilateral Islamic finance institutions, such as the International Islamic Financial Market (IIFM), is essential to their success and may indeed also help the development of Bahrain as a center for Islamic finance. Our work with IIFM is focusing primarily on developing market-led global standards rather than fostering specific financial centers. We are also aware of several other jurisdictions' efforts to promote Islamic finance – notably Malaysia in South-East Asia and the UK in Europe. Governments can help the development of Islamic finance through ensuring a level playing field with conventional finance by liaising with multilateral institutions such as the Islamic Development Bank, the Accounting and Auditing Organization for Islamic Financial Institutions, the Islamic Financial Services Board and IIFM – mainly by adapting their prudential (and accounting) and fiscal regimes and fostering a suitable human resource base."

WHAT'S THE NEW BUSINESS?

The GCC region has for quite some time been experiencing an upsurge in liquidity due to rising oil prices. Besides that, a growing number of middle class investors and structural reforms that are encouraging private provision in areas such as pensions have induced customer demand for Islamic investment funds. Furthermore, the recent burst of the equity asset bubble has elevated the need for professional asset managers and diversified investments. All these factors point to a market opportunity for funds business in the region generally and Bahrain specifically. The market in Bahrain has witnessed the proliferation of products that enable the investors to place their savings in a wide range of Shariah compliant funds including equity, commodity, real estate and Ijarah funds.

"As at April 2007, CBB had approved over 2,000 funds with almost 40 Shariah compliant funds"

Rasheed Al-Maraj, the governor of CBB, during the World Islamic Fund and Capital Markets Conference 2007, highlighted that Bahrain was an early mover in the funds industry by developing the first proper regulations for collective investment schemes in the early 1990s. The CBB has from that time focused on providing the necessary legal and regulatory framework to enable the industry to capitalize on this sector. This includes the development of a new investment business rulebook that provides a guideline for activities like asset management, fund administration and custody services. CBB is also updating the regulations governing the collective investment scheme to allow expert schemes that will be subject to less restrictive guidelines but subject to limitation of their investor base. Consequently, as at April 2007, CBB had approved over 2,000 funds with almost 40 Shariah compliant funds. The Islamic fund industry in Bahrain has been growing at an annual rate exceeding 20%, representing US$1 billion of assets out of US$9 billion in total fund investment.

"Most investments in Bahrain and the GCC in general are concentrated to the real estate market"

Some recent Shariah compliant funds include Deutsche Bank's DWS Noor Islamic Fund launched in December 2006. Deutsche, through its global mutual fund arm DWS Investments, developed DWS Noor Islamic Funds to meet the specific needs of Islamic investors and targeted retail and institutional investors in the UAE and Bahrain. In May 2007, Citibank Bahrain entered into a distribution arrangement with DWS Investments to make available to its customers the full range of DWS investment products, which also include the Shariah compliant DWS Noor Islamic Funds. For a minimum investment of US$5,000 in DWS Noor Islamic Funds, investors will benefit from the potential to invest in all regions and sectors, including the option to participate in IPOs.

A REAL ESTATE BUBBLE?

Regardless of the expansion into the fund industry, most investments (including the new funds) in Bahrain and the GCC in general are concentrated to the real estate market. "Islamic banks are growing like mushrooms here in Bahrain, however most investment activities are focused into real estate. If there were to be a real estate slump in the future, this region will be hit first." Sharifah, with the privilege of having experienced operations in Bahrain, highlights her concern.

She emphasized two main reasons for the real estate investment focus by banks. First, the GCC region has a different investor base compared to the Asian region, for example. Most investors in the GCC comprise of high net worth individuals. These individual investors would be interested in investment opportunities that are short term (maximum five years) and provide high returns. They do not want to lock in their money in an investment for a long time. Secondly, there is a high demand for housing and commercial building development. The economy is experiencing growth and thus increasing the employment level. People, therefore, are looking forward to owning houses. "Eskan Bank for example is also actively involved in the development of the real estate sector of the Kingdom of Bahrain. Towards this end, it undertakes both commercial and residential projects. Of interest, Eskan built the Seef Mall, which is currently Bahrain's largest shopping mall," Sharifah noted.

Sharifah, who is also a capital markets update follower, senses the forming of a real estate bubble in the region. "There is currently too much focus on real estate. If we analyze the real estate market, a downturn has already started in the US. We can see how the rates are hiking causing a series of defaults in mortgage-backed securities. We can also observe a similar hike in rates in the UK, however of a smaller degree. We do not feel much heat in this region because we have excess liquidity, however the time will come for the bubble to burst because we are indirectly exposed to these trends

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New Islamic Finance Opportunities in Bahrain (continued...)

via our overnight rates, which are pegged against the US dollar. Just look at the recent equity bubble burst. Why did that happen? In my opinion, one of the contributing reasons was due to too much focus on equity. We are going through the same cycle in the real estate sector," she elaborated.

DIVERSIFICATION ANYBODY?

Players are aware of the current high concentration in real estate and are looking for diversification opportunities. Saudi Arabia, for example, is moving towards infrastructure development including water and power projects. Dubai is diversifying into the transportation sector, including the construction of highways to overcome its traffic problems. Bahrain banks, known to bring funds across the GCC, are looking into these projects as a viable alternative to real estate. They are also looking at geographical diversification. Al Amin Bank for example will launch a new investment fund, Kotak Shariah Fund (KSF) or Kotak Indian Islamic Fund (KIIF) targeting investment in the Indian stock market under the principles of Shariah. The KIIF comprises all class A shares issued in the KSF. It is an open-ended fund, allowing investors to redeem their investments on any business day.

Besides the Indian equity market, the Bahrain Chamber of Commerce and Industry (BCCI) is also looking at opportunities to enhance bilateral business relations with Thailand amongst other economies in the world, especially Asian countries. Othman Sharif, the chairman of Bahrain Asian Traders Committee of BCCI, during the Thai–GCC Business Conference in Bahrain in July 2007, highlighted that the total volume of trade between Bahrain and Thailand had doubled since 2004 and was worth BD129 million (US$343 million). Thailand's ambassador in Bahrain, Phrombubpha Phithak, said that Thai–GCC trade volume should be an eye opener for the private sector players and there is need for the private sectors to work closely to tap the existing opportunities between Thailand and the GCC.

THE WAY FORWARD

Bahrain has its engine well oiled in becoming the region's Islamic financial center. It will however face competition from other centers. This competition should be taken in a positive manner, as Rene of ICMA put it: "Financial centers compete for market share. This is a positive dynamic, which, properly nurtured, promotes excellence." Among the key challenges that Bahrain and the Islamic banking industry in general face is the shortage of a human resource base. Abbas Ameeri, the managing director of Gulf International Bank, highlighted this issue. "Islamic banking is happening and it's going to be big. However, the industry currently faces acute human resource problems. The banks do not have time to train Islamic bankers, so they hire officers from existing conventional banks and offer high salaries to attract these experienced players. As a result it causes inflation and disturbance in the market," he explained.

Identifying problems in the industry and working together to find solutions is the way forward. Bahrain, with the supporting organizations in place and the recent International Islamic Capital Market Conference, is moving towards that line. Efforts are also needed to introduce more diversification in the Islamic banking and finance industry in Bahrain and the GCC region to develop a sound Islamic financial system.

Interview with Ms Aysha Al Jalahma Head Wholesale Islamic Banking Supervision Central Bank of Bahrain

What is your view on the status of corporate governance in Islamic banking and capital markets?
Corporate governance has become the issue of the hour worldwide. It will remain one of the major challenges as long as businesses continue to evolve. Recent business failures have given this issue a greater urgency, where new legislative changes are taking place. One of these regulatory changes stem from the new Basel II requirements, where, among other things, capital charges will be taken against operational risks. Thus, banks will be penalized for poor operational process, resulting in improved corporate governance procedures. Basel II requirements will also result in banks updating their policies and procedures to become more relevant and rigorous, Basel II will also push towards greater transparency and better disclosures. All of these will rout through creating more enhanced and improved corporate governance procedures

For Islamic banks in particular, corporate governance matters are high on the regulators agenda. This is because of the unique characteristics of Islamic transactions that require special attention and understanding.

And in Bahrain?
Bahrain has given prominent urgency to the issue of corporate governance and Islamic banking and has taken a string of measures to ensure best practice is being applied across the board. The Central Bank of Bahrain (CBB) has a long-established policy of applying international standards, which has provided a solid basis for Bahrain's status as the region's leading financial centre. The CBB is also a founding member of many supporting institutions, one of which is the Islamic Financial Services Board (IFSB), which has issued, inter alia, standards promoting good governance procedures and transparency.

What are the key differences between corporate governance in conventional and Islamic banking?
One major difference is the fact that Islamic banks must follow Islamic Shariah guidelines in all their business activities. It resulted in the mandatory requirement that all Islamic banks must appoint a Shariah supervisory board that would ensure their compliance to Shariah requirements. Banks should also appoint an internal Shariah auditor that would ensure the supervisory board's rulings are adhered to.

Another major difference is the nature of relationship between the bank and its depositors. The chief contract between the Islamic bank and the depositor is the Mudarabah contract, which is a profit-sharing contract where investment account-holders share in the bank's profit and bear the losses. Thus, in essence, they become partners with the bank, and their interests rank pari passu with the bank's shareholders. As a result, a unique fiduciary relationship between the banks and their customers exists that requires additional risk management measures. Accordingly, the CBB requires additional disclosure for the investment-account holders as endorsed by both the IFSB and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

Do these differences make it more difficult to supervise the Islamic banking industry?
It's not a matter of more difficult, rather than a matter of ability to understand the differences and thus supervise them. The Islamic banking industry has passed its infancy stage and is now at the growth stage, this is the most risky and exciting stage in the eyes of a supervisor, where new products are being innovated every day. Supervisors are faced with the challenge of understanding these products and identifying their risks, so as to design an efficient system to supervise them without curtailing growth. The challenge is not in supervising; rather it is in identifying those risks, and putting in place the infrastructure and standards that will help support healthy growth. The best supervision technique in my view at this stage is to stay close to the markets and support them in the development of new solutions and products, and of course to continue to educate ourselves.

What are the key challenges faced by regulators such as CBB in the context of regulating Islamic banks and financial institutions?
Again, the chief challenge, in my opinion, is staying abreast with the market developments and the timely identification of opportunities and risks involved. Supervision will have to become even more pro-active, risk-focused, and also more resource-intensive.

Another challenge is to increase the awareness about Islamic banking and products. Even though Islamic banking is growing at a very impressive rate, there remain areas where opportunities are yet to be tapped into. Banks are still faced with excess liquidity problems and are in need of short-term vehicles to deploy these surpluses. Recent studies indicate that the GCC has been running current account surpluses larger than China for the past three years!

Basel II presents another challenge to banks. It is a much more complex and sophisticated framework than the original Capital Accord, and its successful implementation will require more sophisticated risk management and comprehensive data capture to be developed. It should be noted however, that Islamic banks in Bahrain have been required to take charges against negligence and misconduct even prior to the implementation of Basel II, thus, they are better prepared to handle operational risk charges as required by Basel II.

Another challenge is the large number of job opportunities that are not met with enough trained individuals. This results in fierce competition to retain high calibre individuals and large employee turnover rates.

continued...

Interview with Ms Aysha Al Jalahma (continued...)

Finally, the limited number of Shariah scholars available in the industry poses another challenge. New Shariah scholars must be trained and prepared to assume future positions.

"The implementation of Basel II / IFSB by January 2008 will result in greater advancement of Islamic banks"

What are the key measures that CBB have implemented in the past year to regulate and ensure high standards of corporate governance in the Islamic banking and financial markets in Bahrain?
Bahrain has made significant progress in terms of institutional reform and regulation including the successful implementation of the single regulator system, where the CBB has become the successor organization to the Bahrain Monetary Agency (BMA). The CBB is now endowed with strong operational independence and a wider range of enforcement powers. This will help the CBB maintain clean markets, a feature that has been one of the strengths of Bahrain's financial system.

The CBB has also developed a comprehensive rulebook for Islamic banks. This rulebook has been progressively implemented since 2004 and is consciously updated to match international best practice. The rulebook contains a high-level controls module, which presents various CBB requirements regarding corporate governance.

Bahrain is very conscious of the importance of creating a level playing field, corporate governance requirements are designed to be uniform between Islamic banks and their conventional counterparts, taking into consideration, of course, the unique characteristics of Islamic banking, thereby the CBB will not penalize one industry over the other. The CBB requirements include the submission of statement of strategy and objectives that is comprehensive and well articulated for a minimum period of three years. In addition, all banks must submit a succession plan at the end of each calendar year. The CBB has regulations with regards to multi-directorship where one board member cannot serve in two licensees within the same license category. At maximum, a board member can serve in two licensees with two different license categories.

Furthermore, the CBB gives utmost priority to the issue of internal controls and segregation of duties. All banks are required to appoint an audit committee that reports directly to the board of directors. Banks are required to take the CBB's approval for members of the board and senior management of the bank. In its decision, the CBB conducts a "Fit and Proper" assessment on these individuals to evaluate their qualifications. The CBB also approves the external auditors and the members of the Shariah supervisory board.

The CBB has also created the quarterly prudential returns that cover six areas, namely capital adequacy, asset quality, management of investment account, earnings quality, liquidity, and corporate governance. This is supplemented by regular on-site supervision. Finally, the CBB is also supporting the corporate governance standard issued by the IFSB.

What efforts, other than those taken by CBB, are needed to alleviate the problems?
Jurisdictions need to intensify their commitment to achieving greater alignment and convergence in terms of the accounting standards. This could be achieved through greater acceptance by more jurisdictions of the accounting and auditing standards issued by AAOIFI. Greater alignment is also needed in terms of laws and financial regulations.

Regulators are also encouraged to provide further support and recognition to the prudential standards issued by the IFSB through committing to implement these standards. There is also the need to develop standard contract designs and associated documentation. A task the International Islamic Financial Market (IIFM) has committed to achieve.

Where do you see Islamic banking and finance in the coming years?
The implementation of Basel II / IFSB by January 2008 in Bahrain will result, in my opinion, in greater advancement of Islamic banks. This will force Islamic banks to become more sophisticated and resource intensive. It will help banks develop more advanced programs that are designed to allocate capital more efficiently. Banks are also continuously increasing their capital, which will eventually result in Islamic banks being able to create critical mass. In the long run these capabilities coupled with the strong growth and massive opportunities still untapped, will result in Islamic banks being able to penetrate new markets, compete with bigger institutions, and grab a bigger market share.

Interview with Ijlal A. Alvi, Chief Executive Officer of IIFM

IIFM is aiming to develop the Islamic capital market through standardization. Would you explain more about this effort?
This is one of the areas that we're looking at. We are not going to standardize, but we will be providing templates. It's not going to be enforced; rather it will be the best practices for the market, which should help develop a more efficient capital market.

As Habib Motani explained in the primary market session, best practices would help build an efficient market because when people are given 24 hours to make a decision, they can assume that the structuring and documents are based on best practices. This helps fast decision-making and the market therefore would become more efficient and more liquid. Currently this is our endeavor and maybe later we can look at the possibility of developing some products.

Why is harmonization important?
Harmonization is important to create linkages between the market players. It's very important to have standard documents in certain areas because it would enhance liquidity in the market, reduce the transaction costs of the parties and mitigate legal risks in contracts. We are not going to do it for every product and every contract. We will focus on the instruments that are used by the wider market, for example the treasury Murabahah, which a lot of jurisdictions are using currently. Similarly we'll be coming out with a benchmark hedging instrument for the industry.

Some say standardization will kill creativity. What is your comment?
I think it's a common misconception out there because they don't understand. Just like the misconception regarding our hedging project – we are looking at risk management tools and not derivatives for speculative purposes. As I said earlier, we are not going to standardize each and every contract and product. We will only provide a template-like document which will have room to incorporate each party's specific needs and requirements. We are looking at the possibility of developing harmonization with flexibility. It is not aimed to kill innovation and competition.

What projects do IIFM have in the pipeline?
First we have our own commodity/treasury Murabahah project. Clifford Chance is our legal counsel for this project. If we look at market practice, there are more than 20 different agreements on commodity Murabahah that are being floated in the market. This is not efficient. Thus we are looking at developing a more standardized document for the efficient running of the industry. Our working group on this project has identified the three most commonly used structures of commodity Murabahah and these have been put into a structured paper for review by the Shariah scholars. We've obtained an initial response that there is no fundamental issue with the structures and if everything goes well, we are aiming to have the standardized contract ready by the end of this year.

The second main project involves a joint effort by ISDA and IIFM to develop a master agreement for Islamic hedging. A hedging framework document has been drafted by our working group covering representation, governing law issues, netting and set-off issues. Currently there are no products in the framework document. Later, if the industry needs a certain product, IIFM could move towards the development of such a product.

Another primary project is being developed with ICMA. The main concerns are to develop a vibrant primary and secondary Islamic capital market. In the primary market area we are looking at the possibility of developing a Sukuk issuance recommendation and guideline. We would of course start with common structures in the market like Sukuk Ijarah. Currently everybody has their own way of doing things and this has resulted in a long structuring process. With the guidelines in place, we hope it will help the market to structure the Sukuk in a shorter time and encourage more frequent issuance.

Within the realm of the secondary market, we are in the initial process of developing an Islamic repo, as this would bring liquidity in the market and stimulate an active secondary market trading. No specific product is in place as yet; we have only begun initial discussions.

Besides the primary and secondary market projects, we are also working with ICMA to develop the general market infrastructure. We are exploring ICMA's tracking system, specifically the reporting and settlement system to be applied for Islamic products. Finally we are also identifying Islamic capital market education opportunities with ICMA.

We carry out these projects with a clear focus. We don't want to do 20 things and not accomplish even one, that's very critical.

IIFM does seem to have a number of projects. How will you ensure their smooth running?
We do not accomplish all of these projects on our own. We form working groups for each project and invite institutions to come and participate. As at 2006 IIFM had 35 members, however the working groups are open to non-members as well, and we have about 70 institutions joining us thus far.

How do you see the industry progressing?
The growth of our industry is impressive, however it is a bit fragmented. There is a need for institutions to be linked together. This is an area that still needs to be improved. Institutional development is critical and a lot more needs to be done I think, and this is where IIFM plays its role.

What would your final note be to the readers?
We are providing a good platform for institutions to come and develop our industry together. We are not developing a commercial product. Institutions should come forward and share ideas for the betterment of the industry as a whole.

Second International Islamic Financial Market Conference

INTRODUCTION

The International Islamic Financial Market (IIFM), an international institution focused on the development of the global Islamic capital market and money market, successfully organized its second specialized technical conference in Manama, Bahrain, on the 18th and 19th June 2007.

The two-day conference under the theme "Developing the Global Islamic Financial Market," focused its discussion on pressing issues in the industry including Islamic liquidity management, Islamic inter-bank market, Islamic REITs and unit trust plus the Islamic hedging mechanisms which attracted over 270 leading officials from central banks, industry experts, practitioners and academics from all over the globe.

Keynote addresses during the event were made by the governor of the Central Bank of Bahrain, H.E. Rasheed Al-Maraj, senior advisor of the World Bank, Wafik Grais, the president director of Bank Muamalat Indonesia, Riawan Amin, and the CEO of the International Centre of Education in Islamic Finance (INCEIF), Agil Natt.


H.E. Rasheed Al-Maraj

"The Islamic finance sector continues to demonstrate strong growth; however the challenge is to achieve greater alignment and convergence in the industry. This requires further progress in the accounting standards as well as the prudential standards. In addition, there is also a critical need for standardization of Islamic contracts that is instrumental in encouraging a more liquid Islamic capital market, and in many ways explains why we are here. I would like you

continued...

What was said?

"This is a good initiative. The content of the conference is excellent and the panel of speakers are knowledgeable and experts in the field."
***Kim Vandyke**, Qatar Financial Center*

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"I have gained a lot of knowledge and experience. The discussions presented a practical story of Islamic banking instead of a rosy story of the industry. The panels really tackled the nut and the shells of the market. It's an excellent forum to network/learn/share industry developments. I would highly recommend this forum to everyone with and without Islamic banking knowledge. It's worth my investment!"
***Ahmad Khan**, Retail Service Director, Nielsen*

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"I think it's an excellent event and it provides great opportunity for someone like me to learn from it."
***Arshad Zaman**, ex-Chief Economist, Government of Pakistan*

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"I like the format of the conference because a discussion mode was endeavored rather than a traditional slide presentation mode. This has facilitated the generation of new ideas throughout the event and these ideas were discussed to their logical conclusion. That was very interesting and that's why I think it's a far better learning experience compared to many other similar conferences."
***Pervez Said**, Director of Islamic Banking Department, State Bank of Pakistan*

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"Definitely recommended for institutions looking to expand the spectrum of Islamic banking."
***Ashwin Vijai Kumar**, International Investment Bank*

***

"A very interesting and well-organized event. Most sessions were informative and thought-provoking."
***Timothy Regan**, Head of Legal and Compliance, Eskan Bank*

***

"Knowledgeable and good mix of panelists of industry players and Shariah scholars."
***Mohd Effendi Abdullah**, Director, Islamic Markets and Public Sector, AmInvestment Bank*

***

"Focused and good selection of think-tank."
***Waheed Qaiser**, Managing Partner, Qatar Consulting Company*

***

"A well-planned program with interesting and time-demanding arena."
***Harun-ur-Rashid Chowdhury**, Deputy Executive President, Islami Bank Bangladesh*

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For further information contact:

First Leasing Bank B.S.C.(c)
PO Box 1908, Manama, Kingdom of Bahrain
Telephone: +973 1756 3444
Fax: +973 1758 2887
Email: info@1stleasingbank.com

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Second International Islamic Financial Market Conference (continued...)

to pay tribute to the initiatives that are underway within the industry with the leadership of IIFM to tackle the issues," said Rasheed during his opening address.

This report is a by-product of the conference, embodying full coverage of the keynote addresses, presentations and discussions throughout the two-day event.

The International Islamic Financial Market (IIFM) was established in 2002 by seven founding members: Islamic Development Bank, Central Bank of Bahrain, Labuan Offshore Financial Services Authority (LOFSA) Malaysia, Bank of Sudan, Bank Indonesia, Ministry of Finance of Brunei and State Bank of Pakistan.

In 2006, IIFM was re-launched into a new phase to encourage the development of the Islamic capital and money markets. Following this re-launch, IIFM made arrangements with other international organizations, namely the International Capital Market Association (ICMA) and the International Swaps and Derivatives Association (ISDA), to help achieve its objectives.

The Second International Islamic Financial Market Conference was organized as part of IIFM's mandate to provide a forum for the sharing of knowledge and as an industry-building initiative for the development of the industry.

Khalid Hamad Abdul-Rahman Hamad

IIFM INITIATIVES

In his welcome address at the conference, IIFM's vice-chairman Khalid Hamad touched upon the major initiatives and projects being developed under the guidance of the IIFM. These include the Islamic hedging framework agreement and the treasury Murabahah master agreement, which are being developed in consultation with Islamic banks and other market participants. During the annual general meeting of IIFM on the 17th June 2007, Khalid Hamad elaborated to the members how IIFM works:

1. IIFM will first develop an idea, for example an initiative to develop a Shariah compliant repo.
2. Then, it will seek market reaction, where it will invite all Islamic banks for a discussion. Recently, with the help of ICMA, these market participants were brought to London and IIFM raised the idea at the gathering. IIFM would then analyze whether the market participants need this initiative or not. If the market is not in need of it, then IIFM will abandon or delay the project. IIFM also brings along Shariah experts to the gathering.
3. If consensus is reached on the need for a certain initiative, IIFM will go back to its board to obtain funding.
4. Next, it will form working groups (WG) to develop and deliberate on the right structure or structures (if there exists more than one viable structure). This is the documentation stage. The WG comprises of Shariah and legal experts together with bankers.
5. Once consensus on the right structure or structures is attained, then legal assistance will be sought. Proposals from different legal firms for the master agreement will be analyzed. The master agreement should be flexible enough to operate in any market.
6. Once the documentation is approved by the Shariah supervisory board (SSB) (currently the SSB of IDB), then this documentation will be made available to market players.

Khalid Hamad, who is also an executive director at the Central Bank of Bahrain (CBB), said in his welcome address: "Islamic hedging is a challenging issue and the framework document is important for the industry. It will save time and cost for the industry. With the contributions from the market participants, the objectives can be realized."

"The first draft of the framework agreement for Islamic hedging is complete"

He also informed the conference that currently the first draft of the framework agreement for Islamic hedging is complete and the Shariah board is reviewing it. The framework agreement does not contain any product at the moment; this will be addressed at the next stage. "I hope the institutions that have developed certain hedging products will come forward for the benefit of the industry and share with us their knowledge. Do not take these efforts as competition," he added.

Khalid Hamad also enlightened conference participants about another project of IIFM – the treasury Murabahah master agreement – in which IIFM will play a role in providing transparency and robustness. "The structure paper for the project is waiting for Shariah inputs and drafting by legal counsel will commence soon after," he explained.

EFFORTS TOWARDS HARMONIZATION

H.E. Rasheed Al-Maraj, the governor of the CBB, commended IIFM and the Islamic Research and Training Institution (IRTI) on their efforts and initiatives to further develop the ever-growing Islamic finance market. He highlighted that greater harmonization in accounting standards, prudential regulations and the development of standardized instruments and practices is critical for the sustained development of the industry.

"The existing differences create additional costs for internationally active firms and cause competitive distortions as well as reduced transparency for investors and counter-parties. Of course greater harmonization is a challenge facing conventional finance as well, however, the relative newness of Islamic finance means that the disparities in approaches are somewhat greater in this industry," explained Rasheed Al-Maraj.

With respect to accounting standards, Rasheed Al-Maraj highlighted that the policies set by AAOIFI, the Accounting and Auditing Organization for Islamic Financial Institutions, will provide a solid framework for the industry. Meanwhile, in the field of regulation, he acknowledged that the Islamic Financial Services Board (IFSB) would be able to develop various prudential standards.

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"The third critical pillar for the development of the industry is that of developing standard contract designs and associated documentations. Progress here will be instrumental in encouraging a more liquid Islamic capital market and I would like to pay tribute to the initiatives that are underway within the industry with the leadership of IIFM to tackle the issues. You will hear updates on the initiatives including the development of Shariah compliant hedging instruments, as well as standardized repo and commodity Murabahah contracts," said Rasheed Al-Maraj. He also called on the regulators of various jurisdictions to encourage greater alignment and harmonization via the usage of standardized documents and contracts, where appropriate.


Wafik Grais

Senior advisor at the World Bank, Wafik Grais, during his keynote address highlighted that although initially priority was given to the Islamic banking industry, the Islamic financial market with its Sukuk market performance, for example, has caught the attention of the world. The Islamic financial market has been channeling larger flows of funds and has served various monetary needs. "A liquid and diversified financial market can be a shock absorber and can contribute financial resilience to shocks and financial stability. It could also provide an alternative way of financing economic activities," said Wafik. However, with respect to Islamic financial market, he emphasized that a liquid market has yet to be developed and liquidity management remains a challenge within the industry.

"A liquid market has yet to be developed and liquidity management remains a challenge within the industry"

Wafik shared two important observations for conference participants to ponder upon, in order to achieve a robust Islamic financial market – the enabling environment and the role of Islamic financial market in monetary policy. "The enabling environment calls for consideration to develop the main features of regulation of Islamic financial institutions. Currently, supervision and regulation of Islamic financial institutions varies widely across jurisdictions and this is often associated with confusion in approach and role. For example, Islamic finance would penalize sovereign rating because assessors are unfamiliar with it," he revealed.

To address this issue, he suggested that the Islamic finance industry should learn from its conventional counterpart. "Instead of developing an ad hoc rule for every new instrument and institution, the conventional regulators are moving towards principle-based regulation. In the conventional world, the regulators for example have developed a set of reference principles so the risk assessors have reference in assessing risks. The regulators of Islamic financial institutions may opt to follow this step and manage the diversity that exists in the industry," stressed Wafik. He acknowledged the AAOIFI standards as a good starting point towards managing the diversity in the industry.

His second observation – the role of the Islamic financial market in monetary policy – requires attention, according to Wafik, because currently inflation is rising in the GCC region. "Monetary policy needs to play a role to mop up the liquidity. What can the regulators do in the case of Islamic financial market?" he asked. He hailed Bahrain's effort in devising the Salam Sukuk for liquidity management and called for other jurisdictions to learn from Bahrain's experience.

THE WAY FORWARD

Agil Natt, CEO of the International Centre for Education in Islamic Finance (INCEIF), resumed the second day of the conference with his keynote address emphasizing the human capital development in the Islamic finance industry. According to Agil, the industry of Islamic finance is currently facing an acute shortage of human resource, with a recent forecast estimating that the industry needs 30,000 professionals in the Gulf region alone to support its growth. "This drives compensation packages high and employers find it more difficult to attract and retain good employees. This in turn has driven up the cost of doing Islamic finance business globally," he said.

INCEIF, with an endowment fund from Bank Negara Malaysia, was established in March 2006 and was conferred university status in December 2006. INCEIF was set up with the objective to address the global need for human capital in the industry. "Currently we have more than 800 online students from 44 countries studying our flagship program – Certified Islamic Finance Professional – CIFP. We also admitted 40 full-time students, of which one-third are non-Malaysian, with full scholarship to study CIFP earlier this month (June). In addition, we've also entered into strategic alliances with universities from the Middle East, south-east Asia and the west," Agil highlighted.


Riawan Amin

Riawan Amin, the president director of Bank Muamalat Indonesia, in his opening address, enlightened the conference participants on the essence of Islamic finance – SHARE – which stands for:

- S = simplification
- H = harmonization
- A = alliance
- R = revitalization
- E = empowerment

"Most people in the OIC countries do not understand the set-up of the international economic financial system. For example, when I ask students in Indonesia about hedge funds, only 1% or 2% would be able to answer. This phenomenon indicates a critical situation – if only 2% of the community understands the economic system, then the wealth of the nation will be unequally distributed. Only the minority will conquer the wealth. Therefore, it is vital to have simplification in Islamic finance – to ensure people understand the economic system and thus encourage fair distribution of wealth. This simplification would then lead to harmonization and encourage efficiency," Riawan elucidated.

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Second International Islamic Financial Market Conference (continued...)

He called upon the participants to analyze the current size of the industry and suggested that alliances are critical to help the industry further develop. "We are small and we need to co-operate with others. The liquidity management problem that we are currently facing exists because we do not have economies of scale. Bank Muamalat Indonesia recognized this need and amended its articles of association to allow ownership by non-Indonesian Muslims. This decision has allowed Bank Muamalat to obtain funding from our brothers in Saudi and consequently we were able to expand our business," said Riawan.

"Both revitalization of the current infrastructure and empowerment of the people via education are two important ingredients for the success of the industry"

He concluded that both revitalization of the current infrastructure and empowerment of the people via education are two important ingredients for the success of the industry. "It is a waste if we create new infrastructures just for the sake of being different from our conventional counterpart. It's better to revitalize the current infrastructure and aim for developments. It is important that in this process, we ensure that our conventional counterpart gets infected with the virus of goodness of Islamic finance. Last but not least, an important ingredient for success lies in educating the people and connecting the institutions in Islamic countries. This would help empower the users and the institutions to achieve prosperity."


Ijlal A.Alvi

Closing this successful two-day conference, Ijlal A. Alvi, the CEO of IIFM, highlighted an important message for the players in the industry – "The IIFM will provide a common platform and linkages for the industry to put forward ideas and comments. We are facing challenging and critical issues and I would like to request the institutions out there from the legal advisors, dealing and structuring institutions and all industry players, to come forward and join our working groups so you could contribute for the betterment of the industry of Islamic finance. We are not taking the role of a competing institution in the commercial product. Therefore you are more than welcome to come and share ideas with us for the development of the industry."

Islamic Liquidity Management

DAY 1 SESSION 1		
	Moderator:	**Abdulkader Thomas**, President and CEO, Shape Financial Corporation, Kuwait
	Panelists:	**Bryan Kraty**, Islamic Finance Consultant, Bahrain
		Badlisyah Abdul Ghani, CEO, CIMB Islamic, Malaysia
		Syed Tariq Husain, CEO, Emirates Global Bank, Pakistan
		Collin Willis, Senior Advisor, Calyon Corporate and Investment Bank, Bahrain
		Luma Saqqaf, Lawyer, Linklaters, UAE
		Sheikh Nizam Yaquby, Shariah Scholar, Bahrain

Having excessively high liquid assets, Abdulkader explained, adversely affects a bank's returns and therefore it is important to have an efficient liquidity management tool – to help banks balance their returns and also to meet the need to satisfy withdrawal and other cash requirements.

Bryan started the discussion by updating the floor on the current state of liquidity management of Islamic banks in the GCC. "Banks in the GCC currently have high liquidity on their balance sheets due to a shortage of suitable asset classes to invest in and the anticipation to manage unforeseen redemption and cash flow requirements."

These are some of the liquidity management instruments that are currently utilized by banks in the GCC, as highlighted by Bryan:

1 Commodity Murabahah – this is the most popular instrument among the banks, where banks purchase a commodity on spot and sell it at a higher deferred price. Usually settlement is guaranteed by A-rated conventional banks. Although this mechanism is good for placing funds, it does not help for providing funds.
2. Arab Banking Corporation (ABC) liquidity management tool – by the mid-1990s, ABC had created the first overnight liquidity management tool, where shares of a company owning an underlying pool of assets would be bought and sold. Profit between the banks would be based on the net asset value (NAV). However, this instrument is limited in size.
3. Bahrain Government Salam Sukuk – this provides banks with high quality zero risk asset categories for liquidity management, however again the Sukuk is limited by availability and monthly redemption.
4. Exchange of Qard Hassan – where banks lend to each other on an ongoing point-scoring basis. This allows funding, however it is based on a charitable concept.
5. Reverse Murabahah – this provides banks with means of funding. Here the banks buy the commodity at a deferred price and sell it at spot to raise liquidity.

"Commodity Murabahah has been the most popular instrument, however it is operationally cumbersome. Sukuk provides a longer term solution, nevertheless it is not readily available, not tradeable and the price is not stable for liquidity management," said Bryan. Going forward to managing liquidity, Bryan recommends better co-operation among the Islamic banks. "A central web-based brokerage posting system to advertise the short and long position would improve communication between the banks. Standard documentation and more sovereign Sukuk with zero-weight risk would also help improve the liquidity management," Bryan concluded.

Badlisyah then shared the Malaysian experience in developing the Islamic Interbank Money Market to manage liquidity. "When Islamic banking started in 1983 in Malaysia with a single bank, there was no interbank money market. However, Bank Negara Malaysia (BNM), as the central bank, facilitated the liquidity management either by simple placement with BNM or via the issuance of Islamic negotiable notes. In 1993, the government decided that a single Islamic bank without the ability to interact with other financial institutions was not right for the industry. Then, BNM initiated the Islamic window concept where the conventional banks could offer Islamic financial services, and this gave birth to the Islamic Interbank Money Market (IIMM)."

In Malaysia, the Islamic window concept is governed by the Islamic Banking Act 1983, which does not allow Islamic funds to be placed with conventional banks. They must chase after the Islamic assets. "This fundamentally pressed the need to develop instruments for liquidity management in Malaysia. Today, various instruments are available in the IIMM including Mudarabah, Wadiah, negotiable islamic deposit certificates, negotiable notes from BNM, corporate Sukuk, commercial papers and others. BNM regulates the industry based on the concept of facilitation and when foreign banks came into the Malaysian market and faced difficulty to participate in the IIMM, BNM allowed commodity Murabahah to be added into the IIMM. This is how Malaysia institutionalized the IIMM," Badlisyah explained.

Luma then enlightened the participants on IIFM and ICMA's effort to structure an Islamic repo. "The current commodity Murabahah and the Salam Sukuk have their constraints and limitations. Therefore IIFM and ICMA are looking into the possibility of developing an Islamic repo. Currently, some banks do practice repo; however there is no uniformity in practice. Among the most common structure of repo used include the sale and undertaking to buy back structure and the Salam structure."

The structuring of the Islamic repo does face a number of challenges. First is to figure out how to structure the margin and income payment in a Shariah compliant manner. The next challenge is to identify the underlying asset to be used. What asset could we use? Do we have sufficient Sukuk to be used as underlying asset? Could equity become an asset class that would qualify for Islamic repo? Luma is optimistic in her endeavors: "Conceptually it is possible to structure an Islamic repo, however all the challenges highlighted need further deliberation with the respective parties."

Next, Collin took the role of exploring securitization as a possible solution to manage liquidity efficiently. "The objective in liquidity management is to be able to manage it in an efficient manner. In my opinion, the current use of commodity Murabahah is not efficient

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Day 1 Session 1 (continued...)

for Islamic banks because it has limited product and tradeability. If you enter into a three-month commodity Murabahah, your money is locked in for three months. In addition, it also involves inefficient cost structures due to the additional brokerage costs incurred. If I may add to it, from a Shariah point of view, commodity Murabahah is tolerated rather than encouraged. As a result of these limitations, currently there is too much liquidity in the market chasing too few asset classes for short-term investment."

"If we look at the conventional market, there is a market worth US$2 trillion that offers various asset types including mortgage-backed securities, trade finance receivables, auto loans and credit card receivables. Securitization would be a possible efficient solution. Even in the conventional market, the trend nowadays is to move towards asset-backed securities. For example, 52% of commercial papers in the conventional market are asset-backed. The challenge however, is to identify asset classes that have the depth and the tradeability. We also need to ensure that the recourse is towards the asset itself and not towards the cash flow in order to make it Shariah compliant and tradeable," Collin recommended.

"Currently there is too much liquidity in the market chasing too few asset classes for short-term investment"

The last panelist, Syed Tariq, shared developments in Pakistan with those present. "Islamic banking in Pakistan is relatively new; currently we have four Islamic banks and conventional banks offering Islamic window operations, however the market is still small – the market share is only about 3%. The key feature for further progress is to develop the secondary market. Currently we do not have an instrument to manage short-term liquidity and no lender of last resort. We would face difficulty if a credit crunch was to occur. However, a positive trend is the cross-border banking, where foreign banks are looking for investment in Pakistan and banks in Pakistan that have foreign liabilities are looking for investment outside Pakistan," said Syed Tariq.

Abdulkader then invited Sheikh Nizam to share his views on the topic. Sheikh Nizam drew the attention of the floor to the crux of the problem – what is the reason for the lack of an efficient liquidity management tool? "Commodity Murabahah has been allowed for more than 25 years and Shariah boards show discomfort in this instrument. As rightly pointed out by Collin, it is tolerated rather than encouraged. However, the Islamic financial institutions have yet to come up with a practical solution. The main reason, in my opinion, is the lack of co-operation among the Islamic financial institutions. They do not work collectively. They are selfish. Everybody is trying to catch something alone. This is the reason. In addition, there is also little co-operation between cross-border regulators in this context. Some regulators like Bahrain, Malaysia, Pakistan, Sudan and even Lebanon are moving towards this co-operation, but others are just sitting silently. If the Islamic financial institutions and the regulators could come together, I'm sure they can find a solution," said Sheikh Nizam.

One of the solutions put forward by Sheikh Nizam was the establishment of a mega institution, sort of a clearing house with huge capital. "This mega institution could become the intermediary; providing brokerage, market-making with its department of commodity, metal, Sukuk, foreign currency and many more. It can bear more risks. Commercial banking has limited freedom to take risks because it deals with public money, and these banks are the ones facing the excess liquidity problem. Investment banks, on the other hand, have the freedom to take risks and they do not face a liquidity problem. If we establish this mega institution we will have genuine solutions. It can do many things. For example, it can provide the purchase undertaking in Sukuk Mudarabah and Sukuk Musharakah without raising Shariah controversies like the current practice. Many Shariah scholars do not approve the purchase undertaking in those Sukuk because they see it as a sort of guarantee when the issuing institutions themselves repurchase the Sukuk."

Abdulkader then sought Sheikh Nizam's opinion whether regulators require the underwriters to make market to encourage liquidity in the market as opposed to the mega institution. Sheikh Nizam categorized this as a temporary solution to the problem. "If we want a genuine long-term solution, we need to establish a mega institution. It should not be owned by any majority, thus it would be able to facilitate the repo that we discussed earlier. Currently when the issuer wants to repurchase the security, this will raise a lot of Shariah constraints. However, repurchase by an institution that is not owned by any majority would be allowable in Shariah."

In answering a question from Salman of IRTI as to whether Islamic banks are currently using the right structure in their operations – with short-term deposits on the liability side and long-term financing on the asset side that causes the liquidity problem – Sheikh Nizam said: "You can choose whatever structure you want (bank, finance company, etc...), but once you choose, then you're bound by the rules. The current bank structure has been successful. It has helped the under-banked population. However, the hands of the commercial banks are tied with regulation from central banks, Basel, etc... They

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Day 1 Session 1 (continued...)

have to work within their constraints. The investment banks have more of a free hand and they could take on more risky projects which promise higher returns, however one should not forget that those who invest here must also have the capacity to absorb losses." Badlisyah added that the existence of commercial banks is critical to facilitate the circulation of wealth among individuals and the development of a full spectrum for the Islamic financial system.

Abdulkader asked the panel if currently the industry has sufficient assets to encourage a more liquid secondary market. Luma and Collin shared the view that the assets are there, but are not yet of a sufficient size. However, they noted that the Sukuk market is showing a greater issuance trend and would make up the asset classes required. Badlisyah highlighted the importance of developing the assets in the local market before focusing on global market development. "Currently there is too much emphasis in the GCC to develop the global market. In my opinion, if we do not have a strong base in the local market, then there's no point in entering the global market."

Bryan then highlighted that the establishment of a mega institution would need to consider cross-border jurisdiction and currency issues. In response, Sheikh Nizam clarified that the mega institution could be located in any jurisdiction and it could be owned by everybody. "If we think London would be a neutral place, then let it be in London. Everybody can have ownership in the bank, like the IDB but without that bureaucracy. We want an efficient organization. As for the assets, it can be anywhere in the world. Islamic banks today have assets everywhere in the world; the US, Europe, China, India and many other places. All these assets can be utilized. The issue is to establish the institution. If we don't do this, somebody else will do it ... and the opportunity will go," he reminded everybody.

Hisham Muhammad from CIMB Islamic asked for clarification if there exists a negative correlation between commodity Murabahah and the Sukuk market that prevents the development of the secondary market. Badlisyah referred to the track record of Sukuk issuance and highlighted that banks in the GCC preferred commodity Murabahah over Sukuk, however he said that one has to acknowledge that commodity Murabahah does provide a better yield to the banks. Sheikh Nizam, on the other hand, said that one has to have data and empirical research to answer the question posed. According to Sheikh Nizam, the trend currently shows that Sukuk issuance and commodity Murabahah is increasing. One could even argue that Sukuk has Murabahah as an underlying asset, i.e. the Murabahah encourages Sukuk issuance.

Abdulkader shared the experience of a Saudi bank that wanted to replace its commodity Murabahah with the SABIC Sukuk. "This bank was excited to replace its commodity Murabahah with the SABIC, however when SABIC came out at 40 basis points, the bank faced risk management issues and was only able to replace a limited amount of its commodity Murabahah. These banks always face trade-offs in choosing the risk management capital allocation matrix and the commodity Murabahah replacement decisions."

"Islamic banks hold commodity Murabahah in order to meet the statutory reserve requirement that requires investment in high yield assets.

Collin then shed light on the issue by sharing his experience. "Islamic banks hold commodity Murabahah in order to meet the statutory reserve requirement that requires investment in high yield assets. You get these high yield assets by investing in the commodity Murabahah and not the Sukuk. So, until we develop alternatives for the commodity Murabahah, we're going to face the same issue."

A final question from the floor requested the panel's view on how to encourage banks to issue more Sukuk. Badlisyah explained that the Malaysian market does not face the problem of encouraging issuance, because Sukuk is very competitive in Malaysia and offers tight pricing and cost saving for the issuer. "It's not the case though in the GCC. It seems that it is more expensive to issue Sukuk compared to a conventional bond in the GCC. However, as the market matures, and as the conventional and Islamic investors chase the same asset class – Sukuk – then the pricing will become more competitive and encourage more issuance."

An important conclusion came from Sheikh Nizam. He said, "I wish the Islamic financial institutions will take the initiatives seriously. Otherwise, this problem will remain after 10 or 20 years, and we will come back and complain about commodity Murabahah."

Islamic Inter-bank Market

DAY 1 SESSION 2		
	Moderator:	**Abdulkader Thomas**, President and CEO, Shape Financial Corporation, Kuwait
	Panelists:	**Lillian Le Falher**, Head of Treasury, KFH, Bahrain
		Dr Obiyathulla Ismath Bathca, IRTI/IIUM, Malaysia
		Danie Marx, Head of Treasury and Capital Market, EIIB, UK
		Qudeer Latif, Lawyer, Clifford Chance, UAE
		Sheikh Muhamed Becic, Shariah Controller and Research Analyst, Shape Financial, Kuwait

Abdulkader, after introducing the panelists, invited Lillian to kick-start the session. Lillian, having experience in treasury operations, shared the challenges faced by the industry in the interbank money market. "Currently, the main treasury instrument is the commodity Murabahah. Our main challenge is to think outside of the box of Murabahah. Nonetheless, even within the use of commodity Murabahah we face a problem of non-uniformity of the documents. A lot of transactions are delayed because a document may be Shariah compliant to one bank but non-compliant to another. Therefore, IIFM's effort to come up with standardized commodity Murabahah documentation is very important and timely."

Lillian also highlighted how banks in the UAE (Emirates Islamic Bank and Abu Dhabi Islamic Bank) are exploring alternatives to the commodity Murabahah via the Wakalah model. In this model, institutions would enter into investment agreements based on Wakalah and take out the brokers from the equation. The second challenge that Lillian stressed is the ability of commodity Murabahah to achieve true Shariah compliance. "The market is experimenting with equity Murabahah, for example – where we buy and sell shares instead of commodity. We may be able to structure it in a Shariah compliant manner; however we do not attain the inner satisfaction that it is achieving the spirit of the Shariah," he said.

Dr Obiyathulla then enlightened the floor on the Malaysian experience of the Islamic Interbank Money Market (IIMM). The objective of an IIMM is to enable Islamic financial institutions to have access to liquidity management. The Malaysian Islamic banking sector saw tremendous growth after the introduction of IIMM in 1994. However, it also introduced a new problem to the industry – the Islamic banks now face interest rate risk as much as the conventional banks do. "In my research paper, I studied the movement of the yield of IIMM and the conventional yield. It showed a 90% correlation – this means that both rates move together, i.e. exposing the Islamic financial institutions to interest rate risks."

Dr Obiyathulla emphasized three factors that contributed to this phenomenon:

1 Pricing of the IIMM instruments – currently the instruments are priced based on discounting and the profit rates used are based on interest rates. This is due to the fact that conventional banks are allowed to access the IIMM and the market cannot have two different rates because it would open up room for arbitrage profit.
2. Central Bank operation – to manage liquidity in the market, Bank Negara Malaysia (BNM) uses a similar instrument to the open market instrument in the IIMM. No matter how supportive BNM is towards the industry, it cannot use two different rates or it will open up room for regulatory arbitrage.
3. The Mudarabah investment instrument used in the IIMM pays returns based on the conventional rate.

"Although the IIMM has allowed the growth of the industry, it has invited a new problem. Luckily during the last 10–12 years, we are in the low interest rate regime, however things will change and interest rates will increase. Then, Islamic financial institutions will face problems in managing their exposure," he elucidated.

Danie Marx then deliberated on three drivers that make Sukuk tradeable. Shariah compliance and the environment (legal, tax and accounting framework) surrounding Sukuk issuance would be the first two factors that drive liquidity in the market. However, these factors are beyond the control of practitioners. However, the final driver is within the control of practitioners and this should be the focus of the market. "If we look at the conventional market, liquidity is enhanced via factors like issue size, credit rating, listing on exchange, repeat issuance, price recovery and importantly best practices in documentation and structuring. In my opinion, these are the factors that will attract a broader base of investor and bring liquidity into the Sukuk market like the DIFC, Nakheel and Aldar Sukuk," he said.

Standardized contracts would enhance liquidity in the market, reduce transaction costs of the parties and mitigate legal risks in contracts. Given these benefits, IIFM took the initiative to promote standardized contracts in the industry starting with the commodity Murabahah. Two committees have been formed: the documentation committee (which consists of Clifford Chance and other advisors that helped put together the documents) and the working group from various financial institutions to ensure the global acceptance of the documents. "Currently, the three most commonly used structures of commodity Murabahah have been put into the structured paper and is being reviewed by the Shariah scholars. We've obtained initial response that there is no fundamental issue with the structures and if everything goes well, we are aiming to have the standardized contract ready by the end of this year," Qudeer updated the floor on the IIFM project.

He also shared his view on the need to have standardized Sukuk documents. "As for Sukuk, the market is growing rapidly – from the first IDB Sukuk four years ago, the market has evolved to witness the complex exchangeable Sukuk. We need to develop standardized contracts for common structures like Sukuk Ijarah and Sukuk Mudarabah (after we are done with standardized commodity Murabahah contracts), however for the complex structures, the market is still far away from any standardized documents."

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Day 1 Session 2 (continued...)

Sheikh Muhamed concurred with Lillian's points on Shariah compliance. "We could categorize two levels of Shariah compliance – first, compliance for business purposes that would be easily obtained and the second level – the inner satisfaction that we are truly achieving the spirit of the Shariah. The second level is more difficult to attain and yet is an important point that we must ponder upon." He also shared two other observations from the panel discussions. "In Islamic finance, we should be moving from the money market into the asset market, however with the Murabahah transactions we seem to be shifting from the asset market back into the money market. We also need to be prudent not to mis-use the differences of opinion in approving some structures or practices in the industry."

Abdulkader then asked the panel for reasons why the alternatives to commodity Murabahah (either the Wakalah or Mudarabah model) are not emerging as common practice in the market? Lillian commented: "It depends on which country you go to. In the UAE, the Wakalah model is propagated as the solution to the liquidity management problem, however if we go to Kuwait, they say Wakalah is worse than Murabahah because there are no assets involved. We place our money with an institution and get our profit based on LIBOR. I don't know the solution, but we need to think of alternatives for this problem."

Khalid Yusof from International Holding Corporation requested the panel to discuss the alternatives available besides commodity Murabahah to manage the excess liquidity that Islamic financial institutions currently have. In response to that, Lillian explained the Shariah Compliant Overnight Fund (SCOF) that KFH has developed with Fortis and Luxembourg Stock Exchange. "In this fund, we can invest our money in REITs (for overnight investment) and the units will be traded at the Luxembourg exchange. For obvious reasons there will be additional costs involved (back office staff, listing requirements, etc...) and the fund would only yield LIBOR minus a few basis points. If the Islamic financial institution is ready to shift from business Shariah compliance to inner satisfaction, then the SCOF would be an alternative instrument. However, if the Islamic financial institution is just a rate hunter, then SCOF would not be attractive for them," he said.

Dr Obiyathulla suggested linking the Islamic money market across borders. For example linking the Bahrain LMC and the Malaysian IIMM just like the euro market, where it's linked to the US, Japan, Britain and other markets. "In this way we will internationalize the money market and such a market would not be susceptible to any movement of local interest rate risk." Qudeer, on the other hand, presented the importance of the commodity Murabahah, although it has been controversial. "Commodity Murabahah is the first step to entice the conventional banks. They would not do risky Musharakah transactions. They would first test the water with commodity Murabahah and then move to more sophisticated investments like Sukuk."

Arshad Zaman commented that the industry should draw a distinction between Shariah compliance and fatwa compliance. Fatwa compliance would coincide with the first level of compliance, as explained by Sheikh Muhamed.

In concluding the session, Sheikh Muhamed highlighted the need for Shariah scholars to work closely with institutions in finding new solutions to the problem. Qudeer, Danie and Lillian shared the thought that the industry needs to put concerted efforts into finding alternatives to the commodity Murabahah and, in the meantime, IIFM's efforts will solve a lot of problems in the commodity Murabahah structure itself.

Dr Obiyathulla drew an interesting point: "It seems that the consensus is that Murabahah is something bad and we should go for alternatives. In addition pricing is also a problem. Let me share the Malaysian experience. In the 1990s we have the IIMM based on Qard Hassan but it faced secondary trading problems. Then we moved on to the Mudarabah investment certificate; however the borrowing bank were under-declaring profits when they paid back the money. Finally BNM had to step in and set a minimum return on these investment certificates determined as the government investment certificate yield plus 0.5%. In short, other alternatives have been tried, but there are problems with it. That's why commodity Murabahah is still popular."

Just before the session ended, Salman from IRTI inquired why aren't the institutions commoditizing assets other than the current commodities. Abdulkader explained that Cagamas in Malaysia commoditized housing transactions and this has a lot of opportunities that could be tapped into. However, he noted that commoditization is not actively happening elsewhere. "Most Islamic countries need legal reform regarding ownership and transferability of property to achieve successful commoditization," he clarified.

"An important aspect in the standardization of the Murabahah contract, whether you like or dislike it, is we'll have a good degree of consensus on what we have been doing a lot. IIFM's efforts will help solve and standardize something that we do a lot and it will give us a framework to discuss the next best thing to do," said Abdulkader, wrapping up the session.

IIFM Efforts Towards Uniformity in Islamic Financial Markets

DAY 1 SESSION 3		
	Presentation:	**Ijlal A. Alvi,** CEO, IIFM, Bahrain
	Moderator:	**Qudeer Latif,** Lawyer, Clifford Chance, UAE
	Panelists:	**Pervez Said,** Director/Advisor, Islamic Banking Department, State Bank of Pakistan
		Badlisyah Abdul Ghani, CEO, CIMB Islamic, Malaysia

The session started with a brief presentation by Ijlal explaining the initiatives that IIFM has endeavored to use to bring uniformity to the Islamic financial markets. Ijlal enlightened the audience that IIFM has instigated an interesting concept in the industry through its working group where industry players are brought together on a common platform to share input and ideas. Uniform contracts and products will be developed based on industry need. "If the industry needs certain products, then we will develop template documents and guidelines on it. We are by no means here to compete with institutions that have invested money in their products. Our work is more in the areas that are needed for the advancement of the industry, such as hedging" he said.

Ijlal then explained that Session 3 was set up to gain insights from the experienced panel speakers regarding two specific IIFM projects:

1. The Islamic Hedging Master Agreement – a joint project with ISDA where the hedging framework document has been drafted by the working group covering representation, governing law issues, netting and set-off issues. Currently there are no products in the framework document. Later, if the industry needs certain products, IIFM could move towards the development of such products.

2. Treasury Murabahah – currently there are more than 20 different agreements on treasury Murabahah that are being floated in the market and this makes it difficult for standardization.

Qudeer then took charge of the session and gained the thoughts of the panel regarding the above projects – the harm they may bring, the challenges, the pro and cons and other issues that are of importance to the industry. Qudeer first directed the questions above to Pervez to gain a regulator's perspective on the issue. Pervez highlighted that in banking regulation, the area of focus of the regulators would be the same in supervising either a conventional bank or an Islamic bank. "The regulators would be concerned with its ability to implement the monetary policy, the security of the depositors' money and the avoidance of systemic risk in the banking sector as a whole. The industry may use any tool it feels suitable as long as these factors are safeguarded", he said.

Pervez also added that two imperative points need to be pondered upon in deciding the future of the Islamic finance industry – points raised by Sheikh Nizam Yaquby and Arshad Zaman during the first session and second session respectively. First and foremost, it is important to realize that the liquidity problem that occurs in the industry today is due to the lack of co-operation between the players. "I think Sheikh Nizam has hit the nail on the head. Our problem today is not due to the failure to find a suitable instrument to manage liquidity. The problem lies with the fact that we lack the critical mass that we need due to our selfishness. However, this could not be a burden on the shoulders of the commercial banks alone; they have targets to achieve every minute. As a result, the institutional building has lacked behind. We need collective efforts from the bankers and regulators to rectify this problem" he elaborated.

Another major point that Pervez highlighted was that the standardization of Shariah would not be a practical move to implement at this, the infancy stage of Islamic banking. However, the standardization of fatwa would work and these fatwa could change as and when the conditions and the products change in future.

"Uniformity is something great and should be pursued by the industry," said Badlisyah. "However it should not be confused with standardization of Shariah. Any effort to standardize the Shariah is a total waste of time," he added. Instead, Badlisyah suggested that IIFM should harmonize the approaches that the Islamic banks are taking. He explained that harmonization is achieved when the market is made aware. How could IIFM create this market awareness?

> **"Any effort to standardize the Shariah is a total waste of time"**

"IIFM should consolidate the practice of every financial institution in the industry and compile these into an encyclopedia that is presented in a standard format, so people would appreciate the Shariah ruling underlying a product, together with its advantages and disadvantages. These should be made available as a template to market players and they could choose to practice a product if they agree with the Shariah ruling and leave it if they do not concur with the Shariah ruling. Not condemn it," he recommended.

Regarding the IIFM's projects, Badlisyah agreed that it is a commendable effort to come up with a template commodity Murabahah, however one particular template should not be applicable to everyone. "There should be a basic template allowing for add-in clauses to suit the local requirements. The diversity needs to be allowed for the efficacy of the industry", he clarified. As for the hedging framework, he said it is critical to have a master agreement as the industry is in dire need of it. However, one should bear in mind that the master agreement should be developed at all levels – country, regional, bilateral and global levels. "If we only focus on the global level, then we are limiting our ability to maneuver in the industry" he elucidated.

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Day 1 Session 3 (continued...)

Pervez then shared his experience in Pakistan, when the country took the initiative to standardize the Mudharabah contract. "Initially it had no problem, however when the market grew, the Islamic banks could not change their standardized contracts. Then we changed our approach of standardization; we divided the contracts into two parts – a mandatory section that could not be changed and a guideline that banks may change upon the advice of its Shariah supervisory board. What I'm trying to say is that uniformity should have flexibility. It should not kill innovation and competition."

In answering a question from the floor regarding the need for Islamic banking regulators to solicit exemption from stringent conventional regulation, Pervez strongly disagreed with the suggestion and highlighted that both Islamic and conventional banks exist to manage the flow of funds in the economy via an efficient and equitable manner. Thus they should be governed under the same supervision framework. "Regulation is meant to facilitate, not to kill the industry" he reiterated.

In conclusion, Badlisyah reminded the delegates that we need to start living in harmony. "IIFM should consolidate every instrument in the market and make it available to the market. Then we should take all the instruments full stop! We must not debate in public. We can debate 100% in private to come out with the best products; however we should stop from debating in public that creates confusion in the consumer market."

Pervez concluded his points in a very straightforward question and answer manner:

- Should there be uniformity – Yes!
- Do we need clarity – Yes!
- Should uniformity kill innovation – No!
- Should it kill competition – No!
- Should we standardize Shariah – No!
- Should we standardize fatwa – Yes!

Last but not least, Pervez highlighted that commodity Murabahah and hedging are short-term solutions. They should not be relied upon as a long-term solution. "A long-term solution lies in Sheikh Nizam's recommendation in Session 1 – the industry should establish a mega institution that has the capacity to originate assets, securitize them and make the market. We need to build the critical mass together" he concluded.

Islamic Primary and Secondary Markets

Rene Karsenti, the vice-chairman of the International Capital Market Association (ICMA), commenced this session with a brief introduction to ICMA and its co-operation with IIFM.

ICMA was established 40 years ago to organize the standardization (to the extent possible) of the conventional capital market, which at that time was something new. With ICMA's experience, it is now co-operating with IIFM to develop and standardize the Islamic capital market for the benefit of all parties involved: the regulators, the issuers, the intermediaries and the investors, both in the Islamic and conventional market.

ICMA and IIFM signed an MOU in January 2007 to develop a joint working group with a fivefold agenda:

1. To develop a Sukuk issuance standard;
2. To develop an Islamic master agreement for repo transactions;
3. To encourage secondary market transactions in Islamic products;
4. To develop the market infrastructure, including online matching, reporting and confirmation services for Islamic products; and
5. To identify ICMA's education center utilization for education in Islamic products.

"ICMA–IIFM formed two working groups that had two earlier discussion meetings on the 26th April 2007 and the 18th May 2007. The purpose of this third meeting is to listen and incorporate market players' view into the working group," said Rene.

Rene shared four observations to conclude his briefing:

1. Self-regulation brings more efficiency to the market because it involves faster, more reliable and to some extent more accurate information. Rene stressed that regulators should only intervene when there is a demonstrated market failure.
2. Good market practice should be developed naturally before standardization.
3. Some Islamic capital market practitioners are worried about sharing the same conventional solutions, however this should be examined on a case-by-case basis looking at the needs of the Islamic market.
4. More knowledge-sharing should be encouraged by way of providing scholarships to young scholars to study both Islamic and conventional market knowledge.

Ijlal A. Alvi, the CEO of IIFM, then presented an update on ICMA–IIFM projects: "Currently we are looking into the development of an Islamic repo. Nothing is in place so far, we have only begun initial discussions. Besides the repo project, we are also looking into the ICMA tracking system, specifically the reporting and settlement system to be applied for Islamic products. Last but not least, during the recent London meeting, we discussed primary market issues including the issuance recommendations and guidelines, and more importantly the trustee relationship in Sukuk issuance, because currently in Sukuk offering there is no uniform trustee relationship." Ijlal then passed the discussion to the primary market panel.

Islamic Primary Market Development

DAY 1 ICMA–IIFM SPECIAL SESSION		
	Moderator:	**Professor Mahmood Faruqui**, Vice-President, Institute of Islamic Banking and Insurance, UK
	Panelists:	**Luma Saqqaf**, Partner, Linklaters, UAE
		Habib Motani, Partner, Clifford Chance, UK
		Badlisyah Abdul Ghani, CEO, CIMB Islamic, Malaysia
		Dr Mohamad Akram Laldin, IIUM, Malaysia
		Dominic Selwood, Deutsche Bank, UK
		Waheed Qaiser, Managing Director, Qatar Consulting Co, Qatar
		Jamal Abbas Zaidi, CEO, IIRA, Bahrain

Answering a question posed by Professor Faruqui regarding how to encourage more Sukuk issuance in the market, Luma highlighted two main issues that currently lengthen the Sukuk structuring process. "First, each Sukuk has its own structure and there is no standard practice in place. Therefore, we need to standardize the way Sukuk is approached to shorten the structuring process and therefore encourage more issuance. Secondly, we need to have an asset base that will make Sukuk tradeable. If not, our effort will not go far. Some legal issues like the title transfer and tax issues need to be teethed out to encourage more issuance."

Dominic then elaborated on Ijlal's point in his briefing regarding the role of trustees in Sukuk issuance. "If any investor takes the transaction document, he will not be able to tell clearly the role of the trustee in that issuance – is the trustee a transaction administrator or will the trustee play its role during a default?" he questioned. Dominic requested the IIFM committee to consider this vital point because it will directly affect the growth of the market. He also shared that in the European market, the role of the trustee is standardized so that investors have a clear expectation of a trustee.

Badlisyah reminded the participants that primary market development should be done at two levels – the global and the local market. "To me, higher priority should be given to the local market development. If we look at the US, the UK and Europe, they have an established local bond market. They can go to the market with Islamic papers at any time because their existing legal framework that facilitates bond issuance can facilitate the issuance of Islamic securities as well. Also, please bear in mind that global banks that do not have a local license would not be interested to help develop

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Special Session (continued...)

the local market. Thus we need to take a step back and analyze the situation carefully," he elucidated.

Dr Akram clarified an important point regarding differences of opinion among Shariah scholars. "Sheikh Nizam highlighted in one of the forums that I've attended that 90% of the fatwa in Muamalat are uniform. The scholars only disagree on trivial matters – known as the branches and not the fundamentals. For example, in Sukuk issuance, the scholars approve all forms of issuance – be it Musharakah, Mudharabah, Ijarah, or any other form. This is fundamental. However, when it comes to the add-ons in the Sukuk issuance, like the Wa'ad concept (purchase undertaking) in Sukuk Musharakah and Sukuk Mudharabah, then scholars have differences of opinion as to how far the concept could be stretched. This is the secondary matter that draws differences."

The point explained by Dr Akram has implications for the standardization of documents that currently ICMA–IIFM are looking at. "All contracts could be divided into two parts; the main requirement and the add-ons. Since there are no differences of opinion in the main requirement of a contract, this could easily be standardized. However, when it comes to the add-ons, the standardized contracts should allow for the respective parties to decide their own ingredients," he said.

Dr Akram also called for improvement in the issuance of Shariah ruling (fatwa). "We always see rulings being issued without knowing the basis of the ruling. It's important for the market to know the basis of the decision. The detail of Shariah rulings will help others understand the rationale behind a ruling. At HSBC, for example, we are in the process of compiling the ruling and the background of it so people can have information," he exemplified.

Habib then deliberated how a handbook (like the ICMA handbook) would help to increase efficiency, which would drive up liquidity. "One way to achieve liquidity in the market is by being efficient. To me, efficiency starts with good practice. A handbook (like that of ICMA's) would help identify good practice and set the benchmark for the market. This helps efficiency because when people are given 24 hours to make a decision, they can assume that the structuring and documents are based on best practices. This helps fast decision-making and the market therefore would become more efficient and more liquid." Habib also clarified that the handbook does not specify what one must do; it only communicates what the market expects from the issuer, for example. If an issuer chooses to depart from the best practices, then he should explain the reason for such deviation.

Waheed noted the importance of educating both the conventional market about Shariah requirements and the Islamic market about the conventional market. This, he said, would be an important step to bridge the gap between the markets. Jamal then suggested Sukuk rating as a means to increase liquidity in the market. "Rating provides a different kind of information about the issuer in a simple form to help investors make decisions based on their risk appetite. At IIRA, we have both the credit rating (that analyzes the financial strength of the issuer) and the Shariah quality rating. In Shariah quality rating, we will provide an opinion about how best the issuer has provided resources to meet the guideline by their Shariah committee."

In answering a question from Md. Fayekuzzaman of Islamic Bank Bangladesh regarding the bottleneck in the role of trustees, Professor Faruqui explained that the bottleneck arises because in Sukuk structuring, the trustee of the special purpose vehicle (SPV) is also the trustee in default. Anglo-Saxon law governs the role of trustee and it states that the trustee of the SPV is only a custodian. In the case of default, a professional trustee is required to play a role – not the custodian.

A final closing question came from Razaak Busari of Qatar Financial Center Regulatory Authority (QFCRA) seeking the opinion of the panelists on whether the Sukuk market should be regulated. Badlisyah said that there was no need for regulation in a private placement because there will be no systemic risk. However, when the Sukuk is publicly distributed, the regulators have no choice but to come in. This is to protect consumers and to provide confidence to the market.

Islamic Secondary Market Development

DAY 1

ICMA–IIFM

SPECIAL SESSION

Moderator:	**Ismail Dadabhoy**, Head of the Institutional Banking, UBS, UAE
Panelists:	**Luma Saqqaf**, Partner, Linklaters, UAE
	Habib Motani, Partner, Clifford Chance, UK
	AbdulHak el-Kafsi, Islamic Finance Consultant, Bahrain
	Khalid Yusof, Managing Director, IHG Securities, UAE
	Ali Ahmed Siddiqui, Vice President, Meezan Bank, Pakistan

Ismail Dadabhoy started the ball rolling by posing a question to Ali Ahmed – why do we need repo? This question was in light of the recent ICMA–IIFM project to develop an Islamic repo. Ali noted that repo is important to manage short-term liquidity in a bank. Khalid then shared his experience of structuring a global Shariah compliant equity fund that requires 37% holding in cash, of which the only option was to place it with an Islamic bank due to the scarcity of short-term investment alternatives. Thus Khalid said that repo could be the solution for funds to make short-term liquid investments.

Ismail agreed that liquidity management is one contribution of repo, but based on his experience having worked in repo, he highlighted that repo can play a bigger role in the secondary market. AbdulHak then highlighted another benefit of repo where it can actually stimulate other instruments in the market, including bond and equity instruments.

Ismail then engaged Luma on another issue – would it be possible to structure a Shariah compliant repo? Luma was optimistic in her

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Special Session (continued...)

answer: "We can structure anything in a Shariah compliant manner and repo is one of the easiest to structure because we have ready asset classes for it – Sukuk and Shariah compliant shares. We can structure it based on Murabahah using the shares as an underlying asset or we can also structure a sale with an undertaking to buy back the asset." However, she did not deny there were a few issues that will arise in structuring the repo such as margin call and income payment. She recommended the repo working group to gain information on current market practice in taking margins and security to help resolve the issue.

Ali reminded everybody that instead of focusing on how to structure a repo based on the conventional repo (for example using the buy-back structure, which will raise a lot of Shariah issues), it is better to focus on the needs of the Islamic banks. "We need access to funds – this is our need. In Pakistan, we have inter-bank Mudarabah and Musharakah transactions that help us to manage our liquidity," he explained.

According to Ismail, in the French market repo was utilized via selling securities with an undertaking to repurchase. This structure worked for the French market, until one of the banks decided not to exercise the Wa'ad – this brought collapse to the whole system. Ismail then sought clarification from Sheikh Ubaid regarding the use of the repurchase agreement (Wa'ad) in Islamic banks. Sheikh Ubaid clarified that if the Wa'ad were unilateral (even if bilateral but not binding), it would be allowable in Shariah if the subject matter of the Wa'ad is Shariah compliant.

Khalid suggested that developments of the secondary market in Sukuk should precede the development of repo. He suggested two mechanisms to encourage secondary market trading in Sukuk: First, the issuer should keep some reserve Sukuk for future issuance; and secondly, top Islamic and conventional banks should consider forming a syndicate – like a club – to act as market maker. "The large bid–ask spread currently prevents trading. Big banks acting as market maker would be able to narrow the bid–ask spread," he explained.

Ismail differed with Khalid because, in his view, having repo would allow for secondary market trading in the Sukuk market since it brings the liquidity that is needed for the secondary trading. "And you don't need a club. What you need is bench size issue, rated issue and people committed to make market. For example, when UBS was working with the Khazanah equity-linked Sukuk, there were six banks besides UBS ready to make market. The Khazanah Sukuk is trading and the bid–ask spread is only between 25–50 basis points," he stated.

Luma then provided a bridging view that connects both of the above opinions. "Investors today are asking for different tools for the secondary market. For example some investors ask for a credit default swap as a pre-condition to invest in Sukuk. Thus, it is important to develop both repo and the secondary market together so they complement each other."

"My worry is that, if we don't develop the repo market, the conventional market will develop it and they will soon trade in Sukuk. Then, the Sukuk asset will be used in the conventional market and we will have no asset for the Islamic secondary market," Habib said, raising his concern for the participants to contemplate.

Khalid then sought Sheikh Ubaid's opinion on whether it is permissible to use the conventional repo to encourage the development of the Islamic secondary market under the principle of darurat, in the same way that the Takaful industry was allowed to re-insure their portfolios with conventional re-insurance companies. Sheikh Ubaid responded: "Repo is not a necessity and thus we could not allow it under the principle of darurat. We can use darurat only for extremely detrimental situations. If we allow this, then people would cite it again and again for every simple problem."

Andri Aidham, a participant from Kadir Andri & Partners Kuala Lumpur, supported Sheikh Ubaid's opinion. "Repo is an instrument to maximize profit and get better pricing. From this point this is not a necessity." Luma also agreed with Sheikh Ubaid and Andri. "The asset base for an Islamic repo is already in existence. We just need to structure it. Therefore we do not need to apply darurat in this case."

Ismail then asked for suggestions for a repo structure. Salman from IRTI stressed that the excess liquidity in the market currently is due to insufficient investment alternatives and an existing maturity mismatch. To solve this problem, he recommended two alternatives. "First, we need to find a real economy-linked transaction and commoditize it. Secondly, to increase the Sukuk liquidity, we have to target the small investors. We have to make the denomination smaller so when the small investors face liquidity constraints, they will make market."

Ismail reiterated that repo is not only for liquidity management. "It can also be used for financing Sukuk position. If you want to buy Sukuk but money is tied up in a project, then you can buy the Sukuk and do repo to refinance it. Repo provides credit comfort for a treasurer. He can use his Sukuk as collateral and enhance his portfolio return. In short, repo will oil the engine of the Sukuk market. As a result of this well-oiled engine, an efficient, liquid and tight bid–ask spread will emerge and allow better trading in Sukuk."

Islamic Real Estate Investment Trusts (REITs)

DAY 2 SESSION 1		
	Moderator:	**Arshad Zaman,** Ex-Chief Economist, Government of Pakistan
	Panelists:	**Abdul Rahman Al-Baker,** Executive Director – Financial Institutions Supervision, Central Bank of Bahrain
		Kamal Quadir, Head of Structured Finance, Capital Management House, Bahrain
		Mohd Effendi Abdullah, AmInvestment Bank, Malaysia
		Dr Syed Salman Ali, Islamic Research and Training Institute, Saudi Arabia

Moderator Arshad Zaman, in his brief introduction to the topic, highlighted that there has been a boom in the real estate market globally: the market size has tripled over five years and REIT jurisdiction has developed across the globe. He also noted that REITs are a straightforward Islamic finance instrument, however development has lagged behind and they have emerged late in the game.

Abdul Rahman started the session with a brief presentation on the REIT market. "REITs started in the US in the 1960s and have now expanded into 29 countries. However, 72% of the investment REIT is still located in the US". A REIT is a vehicle that owns and operates income-producing real estate. It opens ways for people to buy skyscrapers, shopping malls, hotels and many other properties. It also provides a steady and predictable cash flow with common stock liquidity.

An Islamic REIT, according to Abdul Rahman, is an investment scheme in real estate where the tenants operate permissible activities. REITs promise a lot of opportunities for development because of the high liquidity in the MENA region complemented by the strong growth of the real estate sector. However, there exist challenges that need to be ironed out. These include the treatment of rental income from mixed activities (permissible and non-permissible), the standardization of Islamic REITs and the clarity of international investors' ownership in local real estate. An interesting suggestion that Abdul Rahman put forward was to aim Islamic REITs at the middle income group of investors, because this would lead to secondary market trading.

Effendi then shared the Malaysian experience in structuring the first Islamic REIT – Al-Aqar KPJ REIT. "In Malaysia, the government issued general REIT guidelines in January 2005 and the Islamic REIT guidelines in November 2005. AmInvestment helped structure the Al-Aqar KPJ REIT in 2006. This was the first listed Islamic REIT globally and it involved properties of a healthcare institution in Malaysia [KPJ Healthcare]. Then the second Islamic REIT was structured in Malaysia using plantation property. Currently there are 10 REITs in Malaysia and two of them are Islamic REITs. As for the problem of mixed activities, the Malaysian Shariah council allows a maximum 20% of rental to originate from non-permissible activities in order for the REIT to qualify as an Islamic REIT."

Kamal continued to enlighten the participants regarding issues in selecting and managing the properties in a REIT portfolio. "A REIT portfolio is like an equity portfolio. It provides return in the form of annual cash flow and capital appreciation. If you buy properties at the top of its cycle, then you cannot expect to enjoy capital gains. Besides that, it is very important to identify what type of asset to invest in. For example, a friend of mine only invests in high rise apartments because people would hesitate to move out. It would be a hassle to move out from an apartment on the 18th floor compared to moving out from a second floor apartment. Currently, the highest yield in US REITs is provided by timberland, due to strong demand in products like paper produce. There are also opportunities in municipal owned properties. Every year these municipals face financial crisis. So they will sell their property to REITs in order to obtain money. For example, recently I was in Boston and the mayor was trying to sell the City Hall in order to relocate it in the business district," he exemplified.

> **"Aim Islamic REITs at the middle income group of investors, because this would lead to secondary market trading"**

Kamal then shared two observations that are important in structuring a REIT:

1. There should be no ambiguity in the lease and REIT documents. This is very important to ensure the documents are enforceable.
2. The selection and management of the underlying asset is very important to ensure the REIT yields high returns. He gave an example of a corporate property investment company in New York during the 1980s that invested US$5.5 billion in power shopping malls. They were enjoying a 15% return for 15 years. Their strategy was to draw the best people and the best tenants into their malls by providing a clean and safe property.

The final panelist, Salman, raised two issues that warrant attention. "What took so long for other countries, beside the US, to develop their REIT market?" he asked. "Other countries only looked at the REIT market during the 1990s. The UK REIT market just started this year. Why did it take so long? I don't have the answer, but I wonder why that happened?" he shared his curiosity. "A REIT is of an Islamic nature even without the permissibility restriction because it links the property with real economic activity. It's not about a barren asset. You must manage the property for you to earn the rental," he clarified.

Salman's second issue concerned the opportunity for cross-border REITs. "According to a property report, approximately US$8.6 billion was raised in real estate funds in the GCC countries. Only 22% of it was invested locally while the balance (78%) was invested outside the region (especially in the UK and the US)," he noted. This statistic calls for cross-border REITs, however OIC countries have ownership

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Day 2 Session 1 (continued...)

restrictions in place where only nationals are allowed to own property. Therefore, some legal reforms must be carried out before we see cross-border listings of REITs flourish. He then highlighted some advantages of cross-border REITs to the originator, the investor and the Islamic finance industry as a whole:

- Originator: REITs can help tap liquidity from a region of surplus.
- Investor: the option is there to buy REITs in a jurisdiction where property rights are more protective and the market system is more transparent.
- Islamic finance industry: the market will converge. When REITs are cross-listed, liquidity will move to better ruled jurisdictions, which means other jurisdictions will be forced to improve. This will bring convergence in market practice.

In answering a question posted by Jamal from the Islamic International Rating Agency (IIRA) on whether rating a REIT would help increase transparency when it is offered to common investors, Kamal said that the market will punish REITs that are poorly structured and not transparent. "Competition will drive out poorly managed REITs. My preference would be, with good clear regulation let the market decide which REIT is good and which one is not."

Islamic Unit Trusts

DAY 2
SESSION 2

Moderator:	**Dr Zaha Rina Zahari**, Director, MAA Assurance, Malaysia
Panelists:	**Mohammed Ayman Al-Tajer,** Director – Financial Institutions Supervision, Central Bank of Bahrain
	Professor Mahmood Faruqui, Vice-President, Institute of Islamic Banking & Insurance, UK
	Roslan Abdul Razak, Director, Business Advisor, Islamic Banking and Finance Institute Malaysia
	Shahrin Shaikh Mohd, Securities Commission, Malaysia
	Dr Burhan Arbouna, Shariah Scholar, Bahrain

Dr Zaha kicked off the session by explaining that a unit trust is a collective fund that allows private investors to pool money and spread risks in an investment. Investors will benefit from the professional management and the reduced dealing costs in unit trust transactions.

According to Mohammed Ayman, investors currently place their money into restricted investment accounts (Mudarabah investment accounts), in which the legal ownership lies with the banks, thus exposing the investors to counter-party (bankruptcy) risks. Instead, if a unit trust structure was adopted for investment purposes, in which the investors owned the investment pool, they would not be exposed to the bank's counterparty risk. For corporate unit trust structures, a special purpose vehicle (SPV) could be established so it will become a tangible legal entity facilitating any legal enforcement. See diagram 1.

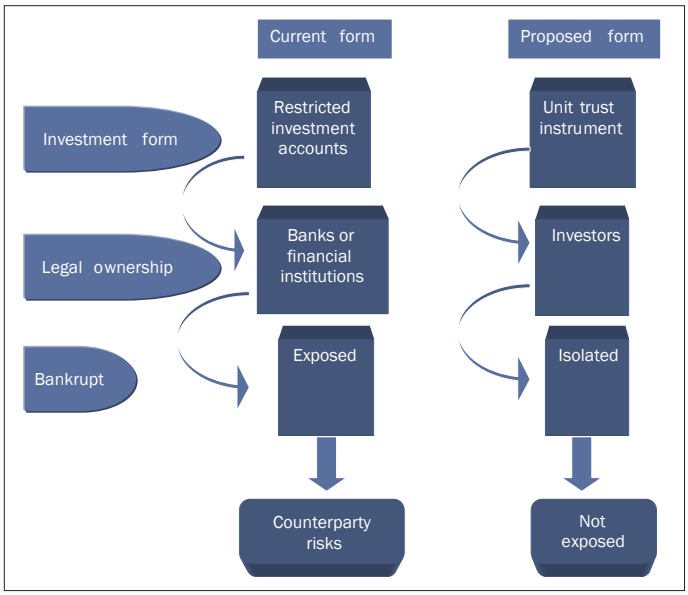

Diagram 1: Structure of investment

Professor Faruqui then shared some of the recent developments in the unit trust industry. He highlighted that Bahrain has taken two initiatives to capture the growing affluent middle class of investor in the GCC and other parts of the world. These initiatives are:

1. Collective Investment Undertaking Rule – allows the establishment of several funds such as the expert fund, exempt fund and specialist fund aimed at sophisticated users with the Central Bank of Bahrain (CBB) providing the platform and friendly regulation.
2. Recognized Jurisdiction Initiative – opens opportunities for funds raised in Bahrain to be invested in other recognized jurisdictions.

He also highlighted that Malaysia has a deep Islamic market, with 89% of its stock being Shariah compliant. In addition, the Securities Commission (SC) has entered into an MOU with the Dubai International Financial Center (DIFC) to allow the cross-border listing of unit trust funds, in a similar way to Bahrain's Recognized Jurisdiction Initiative.

Roslan then introduced the "man on the street's" perspective (i.e. the viewpoint of retail investors). "Today, with increased education and income growth, retail investors are looking for alternative investments besides just bank savings. As a result, unit trust funds have developed a variety of innovative investment options including the equity fund, Sukuk fund, balanced fund (with the sub-classifications of aggressive and defensive balance), REIT fund, hedge fund, sectorial fund and many more," Roslan said. He also pointed out that the establishment of various indices across the globe has given a big boost to the unit trust industry. These include the DJIM and FTSE Shariah Index that was established in 1999, the Kuala Lumpur Shariah Index, and the recent FTSE–Bursa Malaysia Shariah Index.

In Malaysia, there are 36 unit trust operators offering 414 unit trust funds, of which a quarter (98) are Islamic unit trust funds. Among the key growth factors that contribute to development are the availability of Shariah compliant stocks and indices, tax incentives from the government (tax exemption for fixed income instruments and, beginning in 2007, the fee income of fund managers that manage foreign sourced funds are given tax exemption) and a clear regulatory framework and guidelines.

Shahrin then discussed the regulatory approach that Malaysia has taken to encourage the growth of the unit trust industry. "In Malaysia, we apply the two-tier regulatory framework. In the first tier that applies to all unit trust funds, disclosures for investor protection purposes are emphasized. The second-tier regulation only applies to Islamic unit trusts where the SC imposes additional requirements including the Shariah compliance status of the investment, the appointment of two Muslim investment committee members, enhanced disclosure in offering documents and interim Shariah meetings."

Before 2006, unit trust funds in Malaysia solicited investment only from local investors. In early 2007, Malaysia looked into the opportunity to offer the funds to outside investors (south-east

continued...

Day 2 Session 2 (continued...)

Asian and the MENA region investors). In conjunction with this, Malaysia is working with the Dubai Financial Services Authority (DFSA) to facilitate the cross-border listing of unit trust funds. "Two regulatory issues that arise from the cross-border listing include the differences in Shariah opinion and accounting treatments. Malaysia does not adopt AAOIFI standards for its accounting framework. It however follows the MASB-i that was developed based on AAOIFI standards. As for differences in Shariah opinions, we [SC and DFSA] have agreed to adopt a disclosure-based approach where proper disclosure regarding the Shariah compliance of the funds together with the Shariah opinions would be made available to investors. The decision to invest or not will be left to their judgment," Sharin deliberated.

Finally, Dr Arbouna, a Shariah scholar, offered Shariah views regarding issues on Islamic unit trust. "When you mention unit trust, the first thing that comes to my mind is Waqf (because of the word trust). However, from the discussion today, it is clear we are referring to an investment vehicle and not the Waqf. In an investment structure, the relationship between the parties is very important. There are two levels of relationship that must be made clear in this unit trust instrument. The first level is the relationship between the investors themselves. This could take the form of Mudarabah, Musharakah, Sukuk trust and others. The second level of relationship is then between the fund managers and the investor pool. This is usually based on an agency (Wakalah) contract."

Dr Arbouna sought clarification from the panelists as to why the investment is called a unit trust instead of investment pool, for example? He stressed that from his understanding, when the word "unit" is used, it implies that the investor does not own the underlying asset.

Ayman then clarified that the "unit trust" is used because it is based on trust law, which offers protection to the investor. "Trust law ensures that the assets are ring-fenced so that it will become bankruptcy remote assets." Professor Faruqui then highlighted a difference between Shariah and Anglo-Saxon trust law. "The Islamic trust law (Waqf) aims to preserve the community wealth while the Anglo-Saxon trust law preserves the personal wealth of people. Unit trust falls under the purview of Anglo-Saxon trust law," he said.

In answering a question from Muhammad Ozman Faisal Salieh of Amana Investment, Sri Lanka, regarding the presentation of unit trust structure for Shariah approval, Roslan explained that in Malaysia the relationship between the investors in the unit trust fund takes the form of Musharakah. The fund will appoint a fund management company based on the Wakalah contract. Then investment will be made in Shariah compliant stock, Sukuk or Islamic REITs. "If the fund is aiming to invest in other stocks, for example a listed company in Singapore, then it must first seek Shariah approval from the Shariah advisory board. To get this approval, the fund managers must present the prospectus (in the case of an IPO) or three years of audited financial statements (for listed companies) for Shariah screening. If Shariah approval is granted, then the fund manager will proceed with the investment."

" Islamic trust law (Waqf) aims to preserve the community wealth while the Anglo-Saxon trust law preserves the personal wealth of people"

The final question came from Razaak Busari of the Qatar Financial Center Regulatory Authority regarding the concerted efforts in the industry to promote cross-border listing. Shahrin, citing the recent co-operation with the DFSA, explained that cross-border listing requires the authorities involved to agree on a common regulatory framework to facilitate the listing. "We adopted the two-tier approach like in Malaysia. We agreed that the offering documents from both countries must have all the information that the investors need. With regards to differences in Shariah opinion, we decided to adopt the disclosure basis as a resolution." With this explanation, Shahrin concluded the session.

Islamic Hedging Framework and Development

DAY 2 SESSION 3		
	Moderator:	**Ahmed Adil**, Partner, Ernst & Young, Bahrain
	Panelists:	**Sheikh Nizam Yaquby**, Shariah Scholar, Bahrain
		Robert Pickel, CEO, International Swaps and Derivatives Association, New York
		Dr Sami Al-Suwailem, Islamic Research and Training Institute, Saudi Arabia
		Habib Motani, Partner, Clifford Chance, UK

Moderator Ahmed Adil stressed that Islamic banks face business risk just as conventional banks do – they encounter obligor, market, rate, liquidity and operational risks. These risks can generate unexpected losses that need capital insulation, and hedging can help to restrict the impact of unexpected loss. However, he noted that derivatives have drawn a lot of debate as regards to their permissibility. They are said to cause volatility in the market, represent speculation, a zero-sum game, and involve no real economic transactions. Nonetheless, another viewpoint is that some derivatives are permissible because they involve the full transaction price and do not cause injustice to anyone. Ahmed then invited the panelists to share their views on the topic.

Robert explained that derivatives are perceived to be unconventional in the conventional market, however in the context of Islamic hedging, derivates sit in the relative category of conventional. He then highlighted three broad themes that must be understood in structuring derivatives:

1. **Risk**
   There are two principal areas of risk – market risk and credit risk. The early focus of conventional derivatives was in the market risk area (concerned with the price risk of the underlying asset). Lately the conventional market has shifted its focus into the credit risk area. Products like credit default swap, collateralized debt obligation and credit-linked notes are some examples of instruments devised to manage credit risks (i.e. default risks).

2. **Legal issues**
   A number of legal issues have to be resolved to come up with a good derivatives product, including the governing jurisdiction, threshold, enforceability of contracts, collateral, margin and credit support between parties.

3. **Documentation**
   There are three important documents in derivatives structuring: the master agreement (the most important document governing the relationship between two parties); the credit support/collateral document (providing certainty to the parties involved); and the definition template (to develop a hedge for risk at transaction level)

Habib then shared with participants of the session an update on the ISDA-IIFM project. "We are in the process of developing a Shariah compliant master agreement as an initial step to develop an Islamic hedging framework. Currently there is no specific product in place, yet as this would be resolved in the latter stage of the definition template documents."

He also added that the issue of Shariah compliance would be left to the individual parties to decide. "Our working group has decided that the appropriate way to deal with the issue of Shariah compliance is to let each party determine the extent of Shariah compliance they are comfortable with after going through the master agreement." In addition, Habib also clarified that the governing law in the Islamic hedging framework would be either English or New York law, not Shariah law. Netting and dealing issues would also have to be resolved so that both parties will have a fair outcome during default situations.

> **"Our working group has decided that the appropriate way to deal with the issue of Shariah compliance is to let each party determine the extent of Shariah compliance they are comfortable with"**

Dr Sami provided a fresh view on the topic. "Derivatives could be divided into two parts – the instrument and the function of the instrument. If we look at the function (i.e. the objective of risk management), it does not raise any Shariah issues. However, how we manage this risk (i.e. the instrument used) calls for debate in Shariah. The devil lies in the details," he argued.

According to Dr Sami, there are two approaches that can be adopted in product development. First, through replicating a conventional product. For example a swap, repo or future could be used as a starting point, before turning it into a Shariah compliant instrument. However, this is not the most efficient way of product development because there will be additional costs involved to fulfill Shariah requirements, and it's also less creative. The second approach would be to focus on the function of the instrument and the design tools suitable for that purpose. This is what is known as financial engineering.

Dr Sami continued to highlight an important issue: "The concept of risk management entails transferring risk to a party who is able to assume this risk. Thus, we need an institution that will be able to assume risks. There are a lot of institutions that will be able to bear such risks in the conventional market but this is not the case for Islamic banks. Islamic banks are structured to provide financing and not for risk management purposes. While it is important to develop legal documents and master agreement, we should not overlook

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Day 2 Session 3 (continued...)

the development of an institution to assume risks. If not, who will execute the documents that have been developed?"

Sheikh Nizam then acknowledged that risk management problems are genuine practical problems. "The institutions have tried to find solutions for this problem – it may not be innovative and not the most desired way. However, those are practical solutions. It is very important for the institutions to have this tool. If not, they cannot compete with the conventional market and will face losses for no reason. For example a trader who imports furniture from Europe may have a successful trade and have a 50% profit margin. However, due to adverse movement in the currency market, his total profit might be wiped out. Not because he's not a good businessman. It's because he does not have the tools to manage the risk he faces," he elucidated.

"It's ironic to see a 30-year-old industry with so much growth opportunity, without a good think tank to support it"

Sheikh Nizam also emphasized that research and innovation should continue. However, until suitable innovative tools are discovered, Shariah scholars could not ask the parties to wait and do nothing. "We need practical solutions for practical people. If we just sit in our research area and claim that what is being done is haram because it's not 100% Shariah compliant, and it does not comply in substance, then we are asking too much from these institutions and the business community," Sheikh Nizam advised.

Ahmed then solicited questions from the floor and got the ball rolling with his first question. "How do you see us going forward? We usually don't move after conferences?" he asked Sheikh Nizam. In response to that, Sheikh Nizam raised a critical point that needs serious consideration. "It's ironic to see a 30-year-old industry with so much growth opportunity, without a good think tank to support it. Developed nations would allocate 30 to 40 think tanks for every subject, dedicated solely for that task. They will be relieved from other responsibilities. In our industry, we do not have high caliber nor even low caliber think tanks to solve the problems from the source," he said.

Dr Sami fully agreed with Sheikh Nizam's point and quoted how top financial institutions in the UK dedicate 1–2% of their revenue for research purposes. "Islamic financial institutions are certainly behind and we need to take R&D seriously and not occasionally if we would like to move forward."

Arshad Zaman, an ex-chief economist, raised the following question. "I do not see how we can bridge the divide between conventional and Islamic hedging. Instead of modifying a haram transaction, we can say to the party concerned that his question is not comprehensive from a Shariah point of view. In my opinion, hedging would not fit in an Islamic framework," he advocated.

Sheikh Nizam reiterated his earlier example and requested the floor to think of a solution to this practical problem. "If a merchant wants to import €100 million worth of furniture and has to pay the exporter in five months, and he comes and asks me, 'How will I not lose my profit because of fluctuation in the euro?' How would you answer him? You cannot say his question is wrong or Shariah has no answer for this. This is a genuine practical problem. How would you tackle this?" He put the question to the floor.

Dr Sami suggested that Islamic banks could use the Murabahah transaction to solve this problem. "Usually when a merchant approaches a bank to finance an import of merchandise, the bank would first buy the merchandise from the exporter on spot and sell it to the merchant on a deferred basis. The bank can now apply the same mechanism but using different currency. The bank buys in euro and sells in local currency."

This is currently in practice, only it's not institutionalized. He also added another point that must be taken into consideration when structuring a hedging instrument. "Risk management in Islamic finance should aim to integrate risk management with wealth creation (i.e. involved in a real transaction). The conventional market separates these two, thus encouraging speculation because there is no internal limit. Integrating risk management with wealth creation would impose an internal boundary to speculation activities," he recommended.

The moderator, Ahmed, then highlighted that Islamic finance is an evolutionary market and would inevitably face imperfections during the initial stage. "In an evolutionary process, the initial stage would involve questionable transactions. For example, I had the chance to draft a lease agreement when Islamic finance started long ago. Back then, the agreements would always be a one-sided contract where it was structured to protect the big institutions. Nowadays, lease agreements are fairer. It is far better because it has evolved. In an evolutionary process, the initial stage would involve non-100% Shariah compliance."

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Day 2 Session 3 (continued...)

Sheikh Nizam emphasized that there are differences between conventional and Islamic finance. "The underlying asset is different. It has different legal documentation, risk and liabilities. Why has the UK government changed its regulation if it is the same? Why would Singapore need to change its regulation if the two are identical?"

Dr Arbouna, a Shariah scholar from the floor, put forward a suggestion to cool down the heated session. "ISDA and IIFM should look at the functional perspective of derivates and discuss with Shariah scholars if there exists any Islamic product that can achieve the said objective. If such a product exists, then we should use that product instead of the conventional instrument. However, if there is no such product, then we should consider modification of a conventional instrument as an option."

"There exist a lot of frameworks in the conventional market. We should not reject all of them"

He also made a comment on Dr Sami's proposed Murabahah solution for the merchant. "Yes it would help the merchant, however the bank is now exposed to a five-month currency risk during settlement. This will still not resolve the problem," he pointed out.

Robert agreed with Dr Arbouna and explained ISDA's approach. "In the conventional world, we used to start with modification of existing products, however we have now moved on to a stage where we look at the underlying risks and come up with products to manage those risks. The only concern now is to make it Shariah compliant. We will certainly take this perspective in our efforts," Robert assured.

He also noted that most of the debate that occurred centered on specific transactions and products. He said that the current ISDA–IIFM work has not entered into that level yet. "The ISDA–IIFM project is still at the first level – the master agreement level. In this stage we are not looking at any specific transactions yet. The objective of this level is to draft an agreement that will facilitate active trading relationships. All the specific transactions that have been discussed just now will only be looked into in the second level of our work," he clarified.

To conclude the session, Ahmed requested each panelist to share their final thoughts. Sheikh Nizam called upon the participants to support the ISDA–IIFM effort because it will solve a lot of problems. "Every day we face new cases because some lawyer does not accept another bank's contract, maybe because he wants to make more money by adding a few more lines. The ISDA–IIFM documents will solve a lot of problems for the banks, the institutions, the lawyers, the Shariah boards and everybody. I really encourage this initiative," he strongly advocated.

Robert and Habib both promoted cross-border discussions not only to ensure the wider acceptance of the documents, but also to have the best solution possible for the problems at hand. Habib said: "A lot of knowledge is out there. I would encourage them to share with us so we can develop a document with the best thinking in it and broadest acceptance possible."

Dr Sami reminded those present of the need to establish a comprehensive risk management system. "Risk management is an entire field – it's about product, institution and system. In addition to product and documentation, we really need an institution to manage these risks," he emphasized.

"There exists a lot of frameworks in the conventional market. We should not reject all of them. We need to look at each one and evaluate it so we can cut short the long journey that the conventional market has gone through. The ISDA–IIFM project is a commendable initiative and it needs our support to make it a success," Ahmed said, concluding the session.

Interview with Dr Mohamad Nedal Alchaar secretary-general of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

How do you view corporate governance for Islamic banking today?
Corporate governance in the Islamic banking and finance industry (including capital markets) globally has generally improved over the past few years. Both industry participants and regulators have 'raised the bar' on overall implementation of corporate governance practices and disclosure of corporate governance information.

Nevertheless, there is still much that can be done to enhance corporate governance in the industry. In order to support the potential enhancement, AAOIFI has developed a statement on governance principles for Islamic financial institutions, as part of our governance standards.

AAOIFI's other existing governance standards have mainly focused on the Shariah compliance processes for Islamic financial institutions – in reflection of the fact that Shariah compliance is a major component of corporate governance. The statement on governance principles has highlighted that Islamic financial institutions must also incorporate other components of corporate governance.

How does corporate governance for Islamic financial institutions differ to their conventional counterparts?
Islamic banking and finance has additional components of corporate governance. Therefore, Islamic financial institutions must not only adhere to the same corporate governance requirements as conventional practices, but also to the additional requirements specific to Islamic banking and finance practices.

The additional components of corporate governance reflect the wider spectrum of stakeholders in Islamic banking and finance as well as the general expectation for the industry. The majority of risk-bearing funds mobilized by Islamic financial institutions are provided by their customers rather than equity-holders. Although these funds are invested and managed by Islamic financial institutions, the providers of the funds assume the investment risks. Consequently, the corporate governance structure must take into consideration that the fund providers are a primary stakeholder in Islamic financial institutions, and that the corporate governance structure should not prejudice them against equity-holders.

In addition, Islamic financial institutions are expected to comply with Shariah principles in all their activities including their non-finance or non-banking operational practices. They are also expected to contribute towards the development of the societies in which they operate. Therefore, Shariah compliance and corporate social responsibility must also be incorporated in Islamic financial institutions' corporate governance structure.

Does this make it more difficult to supervise?
Although there are additional components of corporate governance in Islamic banking and finance, these should not translate into excessive additional regulatory burden. For jurisdictions where the Islamic banking and finance industry is vibrant and active, the regulators have been generally successful in incorporating the additional requirements specific to Islamic financial institutions into the overall regulatory framework.

What are the key challenges faced by regulators in the context of regulating Islamic banks and financial institutions?
A key challenge, specific to Islamic banking and finance, is ensuring there's a standardized application of Shariah in products offered by the industry. This is particularly important for regulators that supervise Islamic institutions that operate in multiple jurisdictions. For example, Bank A is based in Country Y and also has branches in Country Z. Products that Bank A offers in Country Z may be different to what is accepted and recognized in Country Y (and by Bank A's national regulator).

In order to address this issue, and to promote harmonization of international Islamic banking and finance practices, AAOIFI has developed a series of Shariah standards for global adoption. AAOIFI's Shariah standards provide the basis of uniformity – and give room for innovation – of Islamic banking and finance practices and products across the world.

Multiple jurisdiction operations also highlight the importance of standardized financial reporting by Islamic financial institutions. In this respect, AAOIFI's accounting standards have proven successful in introducing greater clarity and transparency in financial reporting by Islamic financial institutions.

AAOIFI has developed over 70 standards on accounting, auditing, ethics, governance, and Shariah; and the number of standards is expected to continue rising. The standards have already been made mandatory in the leading Islamic banking and finance centers including Bahrain, Dubai International Finance Centre, Jordan, Qatar, Qatar Finance Centre, Sudan, South Africa, and Syria. They are also followed as guidelines in all other jurisdictions that offer Islamic banking and finance.

What key measures, implemented recently, have promised a higher standard of corporate governance?
As mentioned earlier, AAOIFI has developed a statement on governance principles for Islamic financial institutions, as part of its governance standards which is designed to facilitate the establishment of effective corporate governance structures in Islamic financial institutions.

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Interview with Dr Mohamad Nedal Alchaar (continued...)

AAOIFI's statement on governance principles highlights the following as a basis for governance:

- Enhancing confidence
- Shariah compliance
- Business model
- Shareholders' interest
- Social responsibility
- Business ethics and culture.

Based on the above, Islamic financial institutions are recommended to incorporate in their corporate governance structure corporate governance principles that relate to:

- Effective Shariah compliance structures
- Fair treatment of equity-holders
- Equitable treatment of fund providers and other significant stakeholders
- Fit and proper condition for board and management
- Effective oversight
- Audit and governance committee
- Risk management
- Avoidance of conflicts of interest
- Appropriate compensation policy oversight
- Public disclosures
- Codes of conduct and ethics
- Appropriate enforcement of governance principles and standards

AAOIFI's statement on governance principles was developed in close consultation with central banks and monetary authorities, Islamic financial institutions, accounting and auditing professions, and academic institutions. Adoption of the standard will ensure high standards of corporate governance are maintained in the Islamic banking and finance industry.

What efforts, other than those taken by central banks or regulators, are required to alleviate the problems?
The Islamic banking and finance industry as a whole needs to continue to appreciate the importance of corporate governance and to implement the corporate governance structure. Carrying out corporate governance practices will enhance confidence in the industry and consequently place the industry in a strategic position to be able to achieve even stronger growth. Improvement in transparency and content of financial information disclosure will undoubtedly give immense benefit to the industry and its various stakeholders, while enhancement in corporate social responsibility practices will also lend invaluable support to the development of the societies at large.

Finally, where do you see the Islamic finance industry in the coming years?
The Islamic banking and finance concept of sharing risks and rewards is acknowledged to be an attractive and viable option for banking and finance in general. The demand for Islamic banking and finance is set to remain robust, especially if value propositions of this concept continue to be made evident and clear. In the next 3-5 years, with increasing globalization of Islamic banking and finance, the industry may grow in excess of 15% annually.

Structuring Islamic Finance Transactions Financing Al-Waha - A Case Study

By Hammad Hassan

The general overview of the Islamic finance industry portrays a very optimistic picture. Against the backdrop of a regional economic boom, the industry has seen and continues to experience high growth, with the number of Islamic finance institutions growing rapidly. At the same time, most conventional institutions, having realized there is heavy demand, have set up Islamic finance windows that offer Shariah compliant products.

In the middle-east in general and the GCC states in particular, the demand for Islamic finance stems from individuals or 'Savers', and hence the confidence in the longevity of this industry. This is not only true for retail investment and financing products, but also forms the basis for demand on the corporate and investment banking front. As an example of this - in Saudi Arabia, the largest free economic market of the GCC, any project that depends on feedstock supplies from the government is required to offer an initial public offering. For a successful public offering, it is important for Saudi corporations to ensure that all or a major portion of the company's debt is structured in a Shariah compliant manner.

In an environment so buoyant and generally favorable for Islamic financing, there are still many challenges that are faced by providers of Shariah compliant products. In the next few paragraphs, we will focus on some of the key risks that are unique to Islamic financing structures and look at ways of mitigating such risks, through a specific case study.

AL-WAHA PETROCHEMICALS CASE STUDY – RISKS IN ISLAMIC PROJECT FINANCE

The financing of the Al-Waha Petrochemical Company is an excellent case study to look at key risks associated with Shariah compliant structures.

The Project

The Al-Waha plant is being developed in Al-Jubail Industrial City on the eastern coast of Saudi Arabia on a plot of land leased from the Royal Commission for Jubail & Yanbu.

The concept of the project is to take propane gas and dehydrogenate it to produce a polymer grade propylene stream. The propylene produced will then be used by the polypropylene plant to produce homopolymers, produced by polymerization of propylene alone, and copolymers which include a small percentage of ethylene in the polymer chain. The plant will comprise two principal production units: a 460,000 tpa propane dehydrogenation unit and a single polypropylene unit with a capacity of 450,000 tpa. There will also be various additional facilities for power supply, waste water treatment, and cooling seawater supply. The plant is to be constructed and commissioned over a period of 35 months pursuant to a lump sum turn key (LSTK) EPC contract with a consortium of Tecnimont/ Daelim.

The main sponsors of the project are Sahara Petrochemical Company (AlZamil Group is the founding shareholder) and Bassell. Sahara Petrochemicals was formed in 2004 with a capital of SR1.5 billion (US$340 million) to act as a holding company for this project and other investments in the Kingdom's petrochemical industry. Basell was formed in 2000 as a 50:50 joint venture between BASF and Shell, combining all of the partners' polypropylene and polyethylene plants, together with certain ethylene crackers. Basell is the largest producer of polypropylene globally and the largest producer of polyethylene in Europe. In August 2005, Basell was acquired by Access Industries, a privately held New York based industrial holding company founded in 1986 with investments worldwide in the oil, aluminum, coal and telecommunications sectors.

Total Project Costs: US$939.2 Million

Source	Amount (US$ Million)	%
Equity	328.7	35
SIDF Loan	106.7	11.4
Bank Facilities/PIF Loan	503.8	53.6
Total	**939.2**	**100**

Commercial Bank Facility (Islamic)
Total facility size: US$526.5 Million split as,
Base facility (to cover Base Project Cost): US$503.8 Million
Standby facility (in respect of potential increases to base project costs): US$22.75 Million
(The sponsors will contribute US$12.25 Million in respect of potential increases to base project costs in addition to the base equity contribution of US$328.7 Million).

ISLAMIC FINANCING STRUCTURE

The Islamic facility has been structured on the basis of

Pre-completion
- Procurement agreement (Agar Tawreed)
  - Sale / purchase obligation & construction obligation
  - Al-Waha acts as an independent contractor

Post-completion
- Declining co-ownership partnership (Musharakah Mutanaqisah)
- Lease financing (Ijarah Mawsufa fi al Thimma)
- Purchase undertaking
- Sale undertaking

- A co-purchase agreement signed between the investment agent (on behalf of the participants or banks) and Al-Waha, pursuant to which Al-Waha in its capacity as a procurer agrees to take all necessary steps to construct the plant.
- The participants will fund a portion of costs incurred by Al-Waha under the EPC contract and will have an ownership interest in the plant equivalent to the amount of funds plus accrued funding costs.
- At the end of the construction period, the participants will lease their ownership interest in assets to Al-Waha for a period of 11 years.
- During the post completion period, Al-Waha will purchase

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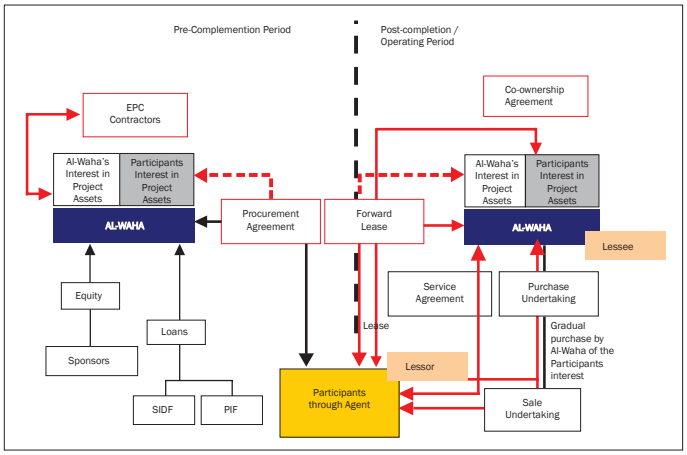
Structuring Islamic Finance Transactions Financing Al-Waha - A Case Study (continued...)

portions of assets owned by the participants at six monthly intervals pursuant to a purchase undertaking.

- An account structure established at the financial close to facilitate the operation of a cash waterfall mechanism. Prior to project completion the account structure will work so that funds from the sponsors, participants and SIDF / PIF will flow through a disbursement account. Following project completion, the waterfall mechanism will follow the principles of a typical project finance structure which treats operating costs as the most senior item of expenditure followed by lease rentals and debt service obligations to the SIDF and PIF.



As the entire commercial debt for the project was structured using a Shariah compliant structure, the risks unique to structuring only are summarized below. Against each risk category, we have also looked at ways in which the risk was reduced or completely mitigated.

ASSET OWNERSHIP

As Islamic financing is based on actual ownership of underlying assets, third party liabilities that do not apply to lenders under a conventional project financing structure; they become applicable to the financier of an Islamic structure.

Under the Al-Waha structure, such risks were mitigated by structuring the procurement agreement as a sale / purchase and a construction obligation. Under the agreement, Al-Waha acts as an independent contractor and not as an agent to the financiers. As Al-Waha acts as principal rather than an agent, third party liabilities remain the responsibility of Al-Waha.

In the post-delivery phase, financiers become the owner of the assets to the extent of their participation. While the legal responsibility of third party liabilities falls on the financiers, by leasing and giving possession to Al-Waha, the risk is transferred to Al-Waha. Furthermore, indemnities are provided by Al-Waha to assume the risk of third party liabilities.

PROCUREMENT OF ASSETS

Failure by Al-Waha to procure the assets / complete the project in time may not be enforceable unless there is negligence or willful misconduct on the part of Al-Waha.

This risk was mitigated by not structuring the procurement agreement as an agency agreement and also by ensuring that complete liability rests on the procurer even in the case of failure without fault on its part.

LEASE AGREEMENT

In case the assets are not ready by the scheduled date, Al-Waha, as per Shariah rules, has the right to claim the total aggregate of advance rental payments from the financiers.
In order to mitigate this risk, the documentation is structured in a manner that such claims are off-set with any claim that the financiers may have against Al-Waha in its capacity as a procurer, for failure to procure the assets

SERVICE AGENCY

Al-Waha's obligation for major maintenance may be terminated by a liquidator under a liquidation.

In case of such an event, the financiers are able to terminate the lease agreement and accelerate the obligations of Al-Waha under the purchase undertaking

SAUDI LAW ISSUES

In Saudi, disputes between banks and their customers are handled by 'banking disputes commission of SAMA' (the SAMA committee) while general commercial issues come under the jurisdiction of the grievances board and other general courts. Being a financial institution, it's preferable for any Islamic facility participants that their disputed cases are referred to the SAMA committee since the said body fully understands banking transactions and Islamic facility structures. The SAMA committee is therefore expected to take a more rational / reasoned approach in case of any dispute between banks and customers for Islamic transactions.

The absence of a typical loan agreement could lead to the matter being presented before the grievances board. Disputes involving Ijarah agreements, service agency agreements or purchase & sale undertakings may be considered non banking matters. The situation becomes more complex due to the lack of precedence for Islamic financing / project financing transactions. Further more, enforceability of general indemnities in service agency agreements and liquidated damages is questionable under the Saudi legal system.

In conclusion, while the project had strong fundamentals and enjoyed support of credit worthy sponsors, the banks or Islamic financiers drew comfort from mitigation of risks arising out of Islamic structuring through proper documentation.

The conclusion drawn above for the Al-Waha project can be extended in general to transactions that are wholly or partially structured on a Shariah compliant basis. As Islamic finance is based on the principles of risk participation and sharing, the risks associated with such structures is higher than their conventional counterparts – however, through careful structuring, proper documentation and support of sponsors / borrowers, most of the risks unique to Islamic financing can either be substantially reduced or in some cases completely mitigated.

The author is executive director of ABC Islamic Bank. He may be contacted at Hammad. Hassan@arabbanking.com.

Equipment Leasing Boom on the Horizon

By James A. Cracco

The equipment leasing industry in Bahrain shares many characteristics with the equipment leasing industry in the GCC and even in the larger MENA region. Bahrain, like the GCC, has the potential for future exponential growth as regional economies become more industrialized, the public and private sector seek alternative sources of capital and the regulatory framework is enhanced. It is fitting that equipment leasing is once again taking root in the region where leasing began (the earliest recorded leasing took place in the ancient Sumerian Empire, in modern day Iraq).

Until recently, equipment leasing was practiced in Bahrain and the GCC on a small scale, mainly through a few traditional banks that provided finance leases as secondary products. In fact, the local business and government communities frequently identify "leasing" with consumer automobile leasing and real estate investing rather than with the global US$600 billion equipment leasing industry that finances one-fifth of the world's annual capital asset investment. Worldwide, equipment leasing is active in virtually all economic sectors and equipment types. Indeed, the global equipment leasing market is served by a variety of lease originators. These lessors include captive leasing companies, which are industrial companies that have set up leasing arms to finance their own in house produced equipment as well as an expanded version of the captive leasing company which finances not only their own products but will also finance equipment from other manufacturers. Some banks have also chosen to make leasing a core business, even to the extent of sometimes setting up a separate subsidiary which often competes — usually effectively — with the parent bank. Banks play an important role in equipment leasing all over the world. That said, the banks usually avoid operating leases and move in and out of the equipment leasing market as they continually redefine and reassess their core competencies. Last, but not least, there are many independent leasing companies, some of which specialize in certain assets or specific lease structures; others have chosen to be "general equipment lessors." One hallmark of the global leasing industry is that there is no "short list" of global leaders. The industry remains highly fragmented. Part of the reason for the number of equipment lessors is the sheer size of the market plus the seemingly infinite number of asset / equipment classes — literally everything from department store shelving to satellites. Given that leasing is (or should be) asset based financing, the lessor must invest a great deal of time and care in understanding the assets' life cycle, the asset product roadmap, and the used equipment market.

Despite the worldwide impact of equipment leasing, the Bahrain and GCC markets have remained relatively untapped. The low levels of equipment leasing are partly because the GCC has been remarkably liquid as it focused on the oil economy. Bahrain, of course, created a world class regional financial services and banking center but neither are asset intensive. At the same time, the private non-oil sector was dominated by family-run businesses with financing not being a major issue. Like family owned businesses in many parts of the world, an "own your own assets" mindset made leasing a very strange option. The expansion of family led businesses into new enterprises and the conversion of closely held companies to stock companies is changing the business model and the fundamentals of managing a company's capital and capital assets. More ambitious expansion plans are encouraging companies to look at ways to use their resources as efficiently as possible. Just as equipment leasing has become part of the economies of the world's most industrialized countries, Bahrain and the GCC are recognizing that equipment leasing offers efficiencies that can contribute substantially to economic growth. As the economies of the region continue to diversify and evolve, the private sector is looking for more profitable ways to employ their capital. Companies are starting to realize that they do not necessarily have to own an asset in order to utilize an asset.

There are essentially two forms of leasing; finance and operating. Finance leases are those in which the lessee pays installments on a piece of equipment with the plan to eventually own the asset. This type of leasing is better known and has existed in Bahrain and the GCC, albeit in a limited way. Operating leases, on the other hand, in which clients only pay for the time the asset is used and return the equipment to the lessor at the end of the lease term, were virtually unknown before First Leasing Bank began offering them to the market. Both of these types of leases have strong potential for further growth in the region.

Bahrain has clearly led the GCC in creating a world standard comprehensive banking regulatory environment. Banks are classified and regulated either as commercial banks or wholesale banks. The Central Bank of Bahrain (CBB) maintains the same classification for Islamic and conventional institutions which are governed under separate regulatory arms. The CBB is currently writing the rule book for financial services which will include equipment leasing.

In part due to the availability of regulations, First Leasing Bank is organized as a wholesale bank. Likewise, more recently formed equipment leasing entities and most existing consumer leasing organizations are formed as banks. The forthcoming leasing regulations will prove pivotal in the development of the business to business equipment leasing industry in Bahrain as well as their ability to compete effectively in the international arena. Generally speaking on a global basis, independent equipment leasing companies are not subject to the heavy bank and/or consumer regulatory environment, thus allowing captive and independent lessors to be more nimble and offer a lower cost product.

Because Bahrain and the GCC is still a market in formation, finance leases are likely to dominate for the next one or two years. Operating leases are just now appearing on the scene and will take some time to assume their normal 25% to 50% market share. The optimistic prediction for leasing is also supported by the strong broader outlook for the regional economy. The GCC's economic boom looks set to last as do high oil prices. This indicates that the Bahrain and the larger region will continue on its path of inward investment, industrialization, and economic diversification. All of those asset intensive activities promise a healthy and exciting future for equipment leasing.

James Cracco is the chief executive officer of Bahrain based First Leasing Bank. The bank is dedicated to serving the finance and operating equipment leasing market in the GCC. First Leasing Bank offers leases for most types of equipment including manufacturing, industrial, maritime, technology, printing, construction, maritime, and transportation.

News Briefs

January

Massive oversubscription
The Central Bank of Bahrain (CBB) announced the oversubscription of its monthly short-term Sukuk Ijarah by 580%. The amount of Sukuk offered was reduced from BD10 million (US$26.6 million) to BD5 million (US$13.3 million) in line with the Bahraini government's bid to reduce public debt. This Sukuk represented CBB's 17th short-term Sukuk Ijarah.

Call for transparent markets
The Central Bank of Bahrain called for a well developed and transparent Islamic capital and money market. Khalid Hamad, executive director of banking supervision at the CBB, also emphasized uniformity and standardization as key issues on which the future of the Islamic financial services industry depends.

"In my view, all of us are partners in the development of the Islamic financial services industry and it is our duty to work and ensure that Islamic business activities take place in an efficient, prudent and sound manner. At the same time, there has to be an adequate financial infrastructure to enable the market participants to conduct their business efficiently," Mr Hamad commented.

World Economic Forum
At the 2007 World Economic Forum held in Davos, Switzerland on the 24th January, Sheikh Mohammed bin Essa Al-Khalifa, chief executive of Bahrain's economic board, elucidated the core shift in the recent growth of the Islamic finance sector.

He also commented on Bahrain's creation of the industry's first regulatory standards. "This regulation in effect legitimized Islamic finance as a global force, by meeting and in many cases, exceeding international transparency standards and providing assurance for investors. The recent significant growth has created certainty for the future, stamping Bahrain's commitment to maintain an optimum economic and regulatory environment for the industry and investors"

GIH enters real estate
Global Investment House (GIH) Kuwait acquired two residential properties in Bahrain via the GCC Real Estate Fund, in a Shariah compliant transaction.

The investment, a joint venture with Alargan International Real Estate, is to take place in Manama. The GCC Real Estate Fund has an 80% stake in the project, with 20% belonging to Alargan. The cost estimate amounts to US$40 million, with the internal rate of return expected to reach 16%.

GIH's first investment will be in a 54,700 square meter plot in Manama, earmarked for a residential community. The development is expected to take 30 months. The second investment, Areej, also in Manama, will be an apartment complex.

Citic stake
Ithmaar Bank – along with two undisclosed investors – paid US$180 million for a combined 60% share of Citic International Financial Holdings (CIFH). CIFH is the asset management arm of Hong Kong-based Citic International.

Ithmaar now owns a 20% share in Citic International Assets Management as part of the acquisition.

BIsB's profits soar
Bahrain Islamic Bank (BIsB) announced profits of BD13.1 million (US$34.7 million) at the end of 2006, up 77%, representing a rise of BD5.7 million (US$15.1 million) from 2005.

Yousif Saleh Khalaf, chief executive officer of BIsB, said: "This rise is due to the continuous growth in the Islamic finance transactions and the various investment activities in addition to realizing attractive returns on the bank's investments in equity holdings and real estate assets."

IDB Sukuk in ringgit?
The Islamic Development Bank planned to raise RM500 million (US$142.4 million) in Sukuk, although no definite date had been set for the Sukuk launch.

Islamic arbitration center
Bahrain announced plans to set up an Islamic arbitration center, to be known as the Islamic Financial Mediator Council. The facility will handle commercial disputes in the country, which has the largest concentration of Islamic banks and financial institutions in the region.

The council is being established by Bahrain's General Council for Islamic Banks and Financial Institutions.

Lagoon City Sukuk a success
The US$200 million Lagoon City Islamic Musharakah Sukuk was successfully closed. The Sukuk was lead arranged by the Liquidity Management Center, and is the largest Sukuk issue in Kuwait for the Al Ahlia Gulf Holding Company.

Liquidity Management Center's chief executive officer, Ahmed Abbas stated, "The Islamic Musharakah Sukuk, which is an international Sukuk, has achieved an over-subscription of US$75 million and the bank has elected to increase the facility to US$200 million making it the largest corporate Sukuk issue in Kuwait to date."

ISLAMIC INTERNATIONAL RATING AGENCY
J. M. McMullen was appointed senior vice-president of rating for the Islamic International Rating Agency (IIRA). Prior to this job, Mr McMullen played a key role in the establishment of the Central European Rating Agency (now Fitch Polska) and Thomson BankWatch Daeil Ratings in Seoul, Korea.

Mr McMullen had also spent a 24-year tenure with Moody's Investors Service, retiring in 1992 as vice-president of financial institutions.

Booming Takaful industry
It was announced that Bahrain had become one of the fastest emerging Islamic insurance hubs in the world, and Enaya AIG Takaful was set to procure 30% of Bahrain's travel insurance market by the end of August, according to Ayman Al-Aimi, general manager of Bahrain's Enaya AIG Takaful.

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News Briefs (continued...)

February

Shariah compliant oil economy
GCC countries were thriving in the construction and real estate industry due to oil price hikes.

Fahmi Ali Al Jowder, Bahrain's minister of works and housing, affirmed: "An increase in liquidity in the economy coupled with Bahrain's leading role in the emerging Islamic banking sector has spurred the development in the country."

Time to consolidate
Al Salam Bank announced it was considering to consolidate and expand its operations globally.

2007 is witnessing the rapid expansion of Al Salam's product portfolio and network via the introduction of its retail and investment banking services earlier in the year.

Bonjour Francaise!
The International Investment Bank (IIB) acquired a portfolio of real estate in France valued at US$105 million.

IIB acquired a 90% stake in the portfolio, which is located in Paris and Lyon. The bank expects to leverage on strong demand and continued growth for office space in the commercial sectors.

IIB's asset manager partner, with extensive knowledge of Shariah compliant investments, holds the remaining 10% in portfolio ownership.

GIB's highest profits ever
Gulf International Bank (GIB)'s consolidated net income amounted to US$255.5 million for 2006, showing a 26% increase over 2005. The post-tax profits represented the highest profits garnered in GIB's history.

Destination, Syria
The Syrian government introduced new laws to encourage foreign investments and establish an investment authority.

The laws were expected to boost investments in the agriculture, industry, land, transportation, telecommunications, environment, electricity and mining sectors. The government also unveiled a major initiative aimed at attracting more foreign direct investments, allowing 100% foreign ownership of businesses and companies, repatriation of profits and incentives for selected industries.

In relation to Bahrain, the Syrian government expressed its enthusiasm to replicate the country's Islamic banking and Takaful models, as Syria has great market potential in these areas.

Record for Unicorn
Unicorn Investment Bank (UIB) recorded a 27% rise in earnings from US$52.6 million in 2005 to US$66.9 million by the end of 2006.

UIB has significantly strengthened its network and franchise via the opening of an office in the Dubai International Financial Center (DIFC) and the acquisition of a 75% stake in Inter Yatirim Menkul Dergerler AS, a brokerage and asset management company based in Turkey with offices in Istanbul and Ankara. The bank also acquired a 22.2% interest in First Dawood Islamic Bank in Pakistan.

Reef's MoU
Reef, the Real Estate Finance Company signed a memorandum of understanding with the owners of Fontana Towers, The Developers WLL.

The US$130 million waterfront residential project, located in Juffair will feature 400 sky villas and apartments, along with four luxury duplex penthouses within four interconnected towers. The project's marketing and sales will be handled by Landmark Bahrain.

Mr. A.Nabi Al Maa, director of Landmark said: "As an end-user financier, Reef has differentiated itself in the market, and was accordingly our first choice for end-user financing."

Gulf's big investments
It was revealed that Gulf Finance House (GFH) had launched projects and investments worth US$12 billion during the previous seven years.

GFH's investment portfolio includes the Bahrain Financial Harbour, Al Areen Development, Legends Dubailand, Energy City Qatar, Royal Metropolis Jordan Gate and Royal Village.

Esam Janahi, chief executive and board member of GFH affirmed: "We are now taking Gulf Finance House to the next level - deepening investor relationships, growing with discipline, executing, innovating and building strong infrastructural growth."

Basel II for all
It was announced that effective 2008, the Central Bank of Bahrain would issue Basel II to implement capital adequacy and risk management systems for banks.

The decision followed extensive dialogue between the Central Bank and other Bahraini banks.

CBB's Banking Supervision executive director, Khalid Hamad attested: "Basel II places much greater emphasis on risk management and introduces more developed methodologies for measuring capital requirements, with the ultimate objective of strengthening the capital base of banks to better protect against risk of bankruptcy or failure of banks."

Islamic products will also be subject to the system, as the CBB has adopted a comprehensive framework which includes the guidelines of the Islamic Financial Services Board (IFSB) for the capital treatment of Islamic products.

CALYON
Simon Eedle was appointed global head for Calyon's Islamic banking arm. He was previously head of ICC and Treasury for the Americas at Calyon New York.

Mr Eedle replaced Arul Kandasamy.

GULF FINANCE HOUSE
Joe McGrane was appointed head of Gulf Finance House's European Private Equity division. He was previously managing director of the Royal Bank of Scotland Development Capital and has held senior positions at 3i and Charterhouse Development Capital.

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News Briefs (continued...)

SOLIDARITY
Ahmed Radhi, Wiaam A. Malik, Ebrahim Khadim and Nasser Al Awadhi were promoted from officers to assistant managers for Solidarity Takaful, with Mubarak Mousa as accountant and Hameed Ashraf Hussain to technical consultant.

Mohammed Shafeeq Ahmed was promoted to assistant manager underwriting, and Ali Mohammed Hassan as assistant underwriter. Asghar Ghuloom Hussain was also elected the company's underwriter.

Arig's drop
The Arab Insurance Group (Arig) reported a dip in profits from US$48.2 million in 2005 to US$30.4 million in 2006.

Alternative for Bahrainis
The Central Bank of Bahrain approved the establishment of the US$20 million Aman Bahrain Insurance Company (ABIC).

Kingdom rated
The Islamic International Rating Agency (IIRA) assigned credit ratings to Bahrain's financial obligations. According to the IIRA, Bahrain's government finances showed a healthy surplus of 7.6% in 2005, and a healthy GDP at 11%.

Salama's profit boost
Salama Islamic Arab Insurance reported a 65% boost in net profits to US$51.8 million in 2006.

March

Positive but risky
Fitch Ratings' country report on Bahrain's banking system suggested that despite a significant increase in credit, the banking sector had maintained a good asset quality and capitalization.

The report however, also suggested volatility in regional stock markets, a possible property market bubble and regional political instability, were causes for concern and have a potential negative impact.

Although Dubai is vying to be the center of Middle East finance, Bahrain's economic outlook continued to be favorable.

Revving up Shariah
Ithmaar Group signed a commercial partnership with the Bahrain International Circuit (BIC) which was in line with Bahrain's role as a global player in finance and motor sport.

Martin Whitaker, chief executive officer of BIC, commented: "As a business which offers Shariah compliant investment products, a role at the home of motorsport in the Middle East is natural. With this announcement coming in the run-up to the Grand Prix, Ithmaar Group is now placed in the same global arena as other major banks who are involved in the sport, but on home soil in Bahrain."

No room for fraudulence
Al Salam Bank, which had just launched an EMV-compliant, chip-based smart ATM card, also announced plans to launch a Shariah compliant chip-based credit card.

The EMV ATM card utilizes technology from Europay, Mastercard and Visa, allowing point of sale and ATM machines to securely read and transmit card information to the bank. The card had been certified by Visa International, and was set to be accepted globally.

Crossing the Euphrates
Global House Group of Bahrain (Global) revealed it would launch a US$500 million Islamic bank in Syria with Global House Group as its main partner.

Albaraka stable
Standard & Poor's assigned ratings of BBB-/A-3 to the Albaraka Banking Group, stating the bank possessed a stable outlook, which is based on the group's endeavor to implement common risk management practices, address asset quality problems in Egypt and extract larger economies of scale.

Ithmaar's on a roll
Ithmaar Bank approved a cash dividend payout of US$47.7 million, or US$0.135 per share. The 138% hike in distribution was in tandem with Ithmaar's net profit surge from US$37.6 million to US$183.8 million in 2006.

ABC gets a BBB
The Arab Banking Corporation (ABC) received BBB+ ratings for its senior unsecured debt US$2.5 billion euro medium-term notes (EMTN) program. Its subordinated debt rating was assigned a long-term BBB rating, as was its long-term subordinated step-up floating rate notes.

GIB capital increase
Gulf International Bank (GIB) increased its paid-up capital to US$1.5 billion, from US$500 million. The increase represents 50% of GIB's authorized capital of US$3 billion. GIB's total equity increased to in excess of US$2.2 billion, following a 50% hike in dividend payments for 2006.

Sukuk success
The monthly issue of the Central Bank of Bahrain's Sukuk Salam was oversubscribed by 131%.

The initial issue price was set at US$16 million, but generated subscriptions amounting to US$21 million. The expected return on the issue was set at 5.15%, and would mature on the 6th June 2007.

Secondary market calls
Dubai's Islamic finance industry needed the boost that the establishment of a secondary Sukuk market would provide, it was stated.

Dubai currently hosts most of the US$24 billion in listed Sukuk worldwide, but is facing stiff competition from Malaysia, Bahrain, Saudi Arabia, Singapore and the UK. Analysts agreed that the trading of Sukuk papers has to increase within the Dubai International Financial Exchange (DIFX) if market effectiveness and diversity are to be encouraged.

London had recently established the world's first secondary market for trading Sukuk and also revealed that it would extend its capital gains tax principles to accommodate Islamic bonds.

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News Briefs (continued...)

Ministry mandates BIsB
Bahrain Islamic Bank (BIsB) announced plans to finance the construction of an 11-storey office building for the Ministry of Works & Housing of Bahrain. The project is located in Hoora, Manama. The BD5.3 million (US$14.06 million) financing was structured according to a diminishing Musharakah, and has a tenure of nine years.

BIsB charted net profits of BD13.1 million (US$34.75 million) in 2006, an increase of 76.6% from 2005.

BAHRAIN INSURANCE ASSOCIATION
In its bid to further develop the Bahraini insurance industry, the Bahrain Insurance Association (BIA) made a series of new appointments.

Ashraf Adnan Bseisu was appointed chairman of the board of directors and Ebrahim Sharif Al Rayes the deputy chairman. Board members were also assigned the responsibilities of heading different committees, with Yassir Al Baharna responsible of the Communications & Development Committee, Yahya Nooruddin in charge of the Motor Committee, and Younis Jamal in charge of Life, Medical and Takaful.

Mahdi Al Aradi was also handed responsibility of the Property, Casualty and Marine Committee; while Fouad Abdullah Aziz responsible for Legal Affairs. Osama Saadeh was also appointed treasurer, and Philip Dominic as secretary.

ITHMAAR BANK
Ithmaar Bank appointed Maysan Faisal Al-Maskati as executive director of its Private Equity Group. Mr Al-Maskati undertook the responsibilities of sourcing, evaluating, structuring and executing value-oriented private equity investment opportunities globally. He has 10 years' experience as an investment banker, having worked for the Emerging Markets Partnership (EMP).

SOLIDARITY
Gopi Rao was elected general manager of Solidarity's Family Takaful division. Mr Rao, whose industry experience spans 30 years, was mandated to manage all aspects of the business.

Prior to joining Solidarity, Mr Rao was general manager of Bahrain Kuwait Insurance. He also currently lectures at the Bahrain Institute of Banking and Finance.

ERNST & YOUNG
Yaser Alsharifi and John Sanderson joined Ernst & Young as Transaction Advisory Services Group, and Business Risk Services Group partners respectively. They are both based in the Middle East.

ITHMAAR BANK
Kenneth C. Borda joined Ithmaar Bank's board of directors. Mr Borda currently serves as chief executive officer of Deutsche Bank for the Middle East and North Africa region. He has also acted as Deutsche's chairman of the Asia-Pacifi c (excluding Japan).

Mr Borda's tenure at Deutsche Bank spans 18 years, having held key management posts, including regional CEO of the Asia-Pacific, based in Hong Kong, and CEO Australia and New Zealand, based in Sydney.

FIRST LEASING BANK
Khalid Kanoo is now the chairman of First Leasing Bank, replacing Khalid Janahi. Prior to his move, Mr Kanoo was chairman of the Bahrain Chamber of Commerce and Industry and has been active with the Economic Development Board, the Arab Business Council, the Bahrain Stock Exchange and the American Chamber of Commerce in Bahrain.

Mr Kanoo is also currently a partner and group managing director of the Yusuf bin Ahmed Kanoo Group of Companies.

SHAMIL BANK
Mohamed Hussain, chief executive of Shamil Bank, was elected to serve on the bank's board of directors, having spent over seven years with Shamil and served as deputy chief executive and group head for corporate banking. He was also general manager of the Islamic Investment Company of the
Gulf, senior vice-president of Smith Barney Inc, director for marketing and corporate finance for the Bahrain International Bank, and assistant vice-president of the Gulf International Bank.

Mr Hussain also currently advises on the board of directors for Meezan Bank, Eskan Bank, Emerging Markets Partnership, First Leasing Bank, Bahrain Institute of Banking and Finance and the Human Resources Development Fund.

Something's brewing
Stock trading for Takaful International was suspended by the Bahrain Stock Exchange (BSE) following a request from the capital market directorate at the Central Bank of Bahrain. (See story in April)

Allianz makes the cross
Allianz Group of Germany was granted an operating license from the Central Bank of Bahrain.

Allianz Group's 100% owned subsidiary, Allianz Takaful Bahrain, serves as the group's global Takaful hub.

Bahrain's petrochemical interest
Takaful International of Bahrain expressed an interest in investing in petrochemical and real estate developments in Sabah.

Sabah chief minister Musa Aman said the company is attracted to Sabah's vast natural resources and large tracts of land suitable for development.

Jersey eyes the Gulf
Jersey Finance of Britain announced it would include Abu Dhabi, Dubai, Bahrain, Qatar and Kuwait in its fifth formal visit to the Gulf region.

Pierre Horsfall, chairman of Jersey Finance, elucidated: "We will use the opportunity to provide updates on regulatory and legislative developments to the Island's finance industry including a number of enhancements during the last 12 months which have made the Island an even more attractive jurisdiction for Gulf-based professionals writing international business."

Healthier BC staff
Takaful International and Bahrain Credit (BC) signed a memorandum of understanding to provide health insurance to BC staff.

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News Briefs (continued...)

Takaful Re promising
Net profits of US$1.26 million, along with gross written premiums of US$15.04 million, spurred Takaful Re's growth in its first period of operations. The results were despite the re-Takaful operator's late licensing in December 2005.

Takaful's special mention
The chief executive officer of Solidarity, Sameer Ebrahim Al Wazzan, was honored for his service as chairman of the board of directors of the Bahrain Insurance Association since 2000.

Al Salam's endeavor
Al Salam Bank Bahrain acquired a 20% stake in the Aman Bahrain Insurance Company. The Shariah compliant insurance company, which obtained Central Bank of Bahrain approval, would have a start-up capital of BD7.5 million (US$20 million).

April

Vote of confidence
The Islamic International Rating Agency (IIRA) rated Bahrain Islamic Bank (BIsB) with a medium to long-term national scale entity rating of BBB, and a short-term rating of A2.

ABC the 'loan' ranger
ABC Islamic Bank was appointed sole mandated arranger for the International Leasing & Investment Company (ILIC)'s US$100 million five-year, amortizing, revolving Murabahah.

Farukh Zaheer, head of syndications for ABC revealed that the syndication would be available to regional and international banks, once announced.

IIFM workshop
The Central Bank of Bahrain hosted a "Specialized Workshop on Risk Management System and Secondary Market Contract" in order to garner the views of senior bankers on two key initiatives to be implemented by the International Islamic Financial Market (IIFM).

The first was the possible development of Shariah compliant master repo agreements, based on conventional repos developed by the International Capital Market Association (ICMA). The second was a risk management system for Islamic products based on ICMA Trax.

Oversubscribed again
The Central Bank of Bahrain's monthly short-term Sukuk Ijarah was oversubscribed by 340% receiving subscriptions worth BD17 million (US$45.08 million) for the BD5 million (US$13.26 million) issue, which carried a maturity of 182 days.

Golden Belt glimmers
Golden Belt 1's proposed US dollar denominated Sukuk was assigned a preliminary rating of BBB+ by Standard & Poor's.

Moody's also rated the issuance, assigning it a Baa1 rating with a stable outlook.

Proceeds from the Sukuk were to be used to finance an initial head lease payment to Maan Al-Sanea for leasing land parcels domiciled mainly in Al-Khobar, Saudi Arabia. The proceeds would be used for the general funding purposes of Saad Trading, Contracting and Financial Services Co (STCFSC), which is subject to a sub-lease agreement with Golden Belt.

Aussie Rules
Australia was seeking Islamic finance expertise from major Bahraini Islamic banks and financial institutions. The Australian market was looking to tap Shariah compliant structured finance, retail banking and trade finance and Bahrain was selected based on its robust Islamic market.

Australian trade commissioner, Gary Kennedy, said: "Australia is a stable and growing economy which offers a stable political and economic environment to investors and this has led to a major surge in flow of foreign direct investments in all vital sectors. We are very keen to have a free trade agreement with the GCC as the Australian embassy in Saudi Arabia has appointed a consultant to prepare the groundwork for this landmark treaty, which we see as beneficial for both sides. The process will gain momentum shortly."

The ever popular Murabahah
Arcapita Bank doubled the size of its Murabahah facility to US$1.1 billion from its previous US$500 million, in line with a demand excess of US$1.3 million.

More than 80% of demand for the Murabahah originated from outside the Middle East, allowing the bank to benefit from a lower cost capital for its expansion.

Shariah takes to the skies
Al Salam Bank acquired an US$83 million equity stake in Malaysian Airlines (MAS)'s Boeing 777-200ER aircraft. The transaction involved a combination of equity and debt marking Al Salam's second Malaysian deal, following its real estate endeavor in Penang in 2006.

The Lenders
Twenty six banks syndicated a US$405 million term loan facility for the Investment Group and FAL Oil Company. The facility was to finance current operations, refinance selected debt and fund expansion plans. The facility was originally offered in the syndication market at US$300 million, but was oversubscribed by US$105 million.

Tameer Murabahah
Bahrain Islamic Bank was nominated to act as placement agent for a BD4.8 million (US$12,73 million) international commodity Murabahah agreement for the Al Khaleej Development Company (Tameer).

Back in black
Bahrain Islamic Bank reported BD5.2 million (US$13.79 million) in net profits for the first quarter of 2007. This 37% increase from the previous year's BD3.8 million (US$10.07 million) was credit to the bank's overall growth and finance and investment transactions.

BIsB's operating income rose by BD15 million (US$39.78 million), a 66% hike compared with BD9 million (US$23.87 million) in 2006.

Fortis fund for finance
Fortis and Kuwait Finance House Bahrain announced plans to help Persian Gulf Islamic banks manage their money via a fund set-up. The fund would allow Islamic banks to manage short-term liquidity

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News Briefs (continued...)

and create overnight investment opportunities. The Persian Gulf economy is seeing rapid development with record sales from oil and oil derivatives.

Sukuk marketplace
The Sukuk Exchange Center (SEC) domiciled in Bahrain expected to see up to US$600 million in bonds traded in its first year. It was set to commence operations in June 2007. The SEC aims to become the world's first marketplace for Sukuk. Sokouk Holding, International Leasing and Qatar Islamic Bank have contributed US$200 million in start-up capital.

May

Al Salam hub opens
Al Salam Bank opened a regional hub in Bahrain and at the same time launching its Islamic operations. The bank was also granted a license to operate in Algeria, while looking to expand into Syria and the GCC market.

KFHB paving the way
Kuwait Finance House Bahrain (KFHB) announced it would establish a US$50 million investment bank in Jordan. The bank, dubbed KFH-Jordan, will be 100% owned by KFH Bahrain.

GFH energized
Gulf Finance House (GFH) launched a US$395 million private placement to fund the infrastructure for Energy City India (ECI). The investment was expected to bear over 75% in returns over the next three years. Kuwait Investment Company was the issue's underwriters. Energy City India follows GFH's Qatar success with Energy City Qatar.

Khaleeji capital rising
Khaleeji Commercial Bank (KCB) upped its share capital by BD70 million (US$185.68 million) to BD100 million (US$265.26 million). The capital hike accommodates the growing demand for Shariah compliant banking and investment products. The bank's primary focus is on Bahrain, Saudi Arabia and the UAE – which together account for 73% of the GCC region's GDP.

First Islamic private equity fund
Dechert was mandated as lead advisor for Capital Management House's CMH Enterprise Fund I. The CMH Enterprise Fund I planned to invest in manufacturing, utility, energy, healthcare, services and technology-related companies, and is headed by the firm's London-based Islamic finance partner, Abradat Kamalpour.

CBB goes web-based
Information relating to government bonds was made available real-time through Reuters in a move to improve information dissemination from the Central Bank of Bahrain. This followed the CBB's introduction of a webpage for the information provider's real time data clients, initiated in December 2006.

Unified product rules
It was announced that the first standardized Islamic products would be available to Bahraini investors by the end of 2007. The Central Bank of Bahrain was working towards making Bahrain the first market where Shariah compliant products follow a unified set of rules.

IIFM initiative goes to plan
Efforts by the International Islamic Financial Market (IIFM) to develop globally accepted market standards for Sukuk were endorsed by European Islamic and conventional financial institutions.

"We are extremely pleased with the interest we have received from the European financial services industry in developing market standards which will be acceptable across borders," said chief executive officer of the IIFM Ijlal Alvi. "Such initiatives are critical for activating sound, effective and truly global Islamic capital and money markets, both primary and secondary. As an organization focused on the promotion and development of the global Islamic capital and money markets, the IIFM is following a policy of eliciting market feedback from different geographical areas before embarking on a project of this magnitude," said Ijlal.

Sea financing
Marina West and Reef Real Estate Finance Company signed an memorandum of understanding confirming Reef Real Estate as Marina West's first Islamic mortgage finance provider. Under the agreement, Reef will offer Ijarah "lease to own" contracts, with tenures of up to 25 years, to cover property values of up to BD350,000 (US$928,406) per customer.

Smooth exit
Shamil Bank made a successful partial exit of its US$50 million United States Development Opportunities Fund I Limited (USDOF I). The exit materialized via the disposition of its Virginia assets within the USDOF I portfolio. USDOF I – a Mudarabah fund – allowed investors to invest in two condominium projects in Fairfax, Virginia, and Miami, Florida, in the US.

The funds, which were subscribed in December 2005, projected a 17% internal rate of return over two years.

Fostering links
The Central Bank of Bahrain and the Central Bank of Egypt (CBE) signed a deal to increase ties between the two. The deal will see an exchange of information for training, supervision and technical expertise.

Conventional debt
Gulf International Bank (GIB) signed a US$1.2 billion syndicated term loan facility. The facility, which was initially launched back in April was oversubscribed to US$1.46 billion.

Sell-off
Global Securities House and the London-based Islamic Asset Management sold the assets of the jointly sponsored Al Bait UK Real Estate Fund for US$116.5 million. The fund's portfolio of properties comprised a balance of office, mixed use and industrial assets across the UK. Acquired in 2003, the portfolio was sold to the Pan-European Islamic Real Estate Fund.

Ewaan Capital
The International Investment Bank and the Islamic Corporation for the Development of the Private Sector announced it would set up an asset management company in Saudi Arabia. Dubbed Ewaan Capital, the company would have a paid-up capital of US$13.3 million. Its services include capital markets activities, fund management, investment banking and advisory services.

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News Briefs (continued...)

Revolving Murabahah
ABC Islamic Bank launched a US$100 million 5-year amortizing syndicated revolving Murabahah for the International Leasing & Investment Company (ILIC). The facility was fully underwritten by ABC Islamic. Prior to the launch, ABC Islamic was joined by Boubyan Bank, Gulf International Bank, the Islamic Bank of Asia and Raiffeisen Zentralbank Österreich Aktiengesellschaft acting as mandated lead arrangers.

Diminishing Musharakah?
Bahrain Islamic Bank (BIsB) revealed it would provide Islamic home financing to the Bahrain elite via a memorandum of understanding with Riffa Views Signature Estates (RVSE). BIsB will offer two financing programs. The first is the Tas'heel program offered during construction, followed by the Diminishing Musharakah program. Customers are awarded BD300,000 (US$795,711) in property finance, with a 25-year repayment period and 8.5% profit rate. The program is available to Bahraini citizens and expatriates with a monthly income exceeding BD800 (US$2,121.90).

Residential boom
CapitaLand announced it would invest US$130 million in the Shariah compliant Raffles City Bahrain Fund. The fund will invest in a residential and retail projects at Bahrain Bay, CapitaLand.

Liquid returns
Liquidity Management Center gained US$8.9 million in operating revenue as at the 31st December 2006, compared to US$4.4 million in 2005. The bank's net profit stood at US$6.1 million, with total assets standing at US$220 million and shareholders' equity at US$58 million.

Sukuk up for grabs
Liquidity Management Center was mandated to launch Al Imtiaz Investment Company's US$75–150 million Sukuk. LMC would act as the Sukuk's mandated arranger, structuring advisor and placement agent. The three-year tenured Sukuk is structured based on the Islamic Investment Agency.

IIFM stays focused
The International Islamic Financial Market (IIFM) launched a focused program to develop benchmarks and increase standardization. The program is specific to Islamic capital markets, although the IIFM also plans to standardize the structure and documentation for commodity Murabahah. Ijal Alvi, chief executive officer of the IIFM, stated that the commodity Murabahah master agreement would be voluntary to adopt, and would be implemented between June and September 2007. After the IIFM's temporary cessation in activity until 2006, Ijal admitted: "It was hard to get market confidence back. The acceptability of the IIFM has, however, improved in the sector. Our approach is very focused now."

Record high
Shamil Bank's net income grew by 151% to US$28.39 million in the first quarter of 2007, as compared to the same period in 2006.

Move over, Hilton
Shariah compliant hotel group Shaza Hotels was set to open seven properties across the Middle East and North Africa region by 2010. The group's first launch is slated for 2008, along the Sheikh Zayed Road in Dubai. Doha, Muscat, Jeddah, Bahrain, Cairo and Marrakech properties have also been earmarked for expansion.

CALYON
Safdar Alam left Calyon in order to join JP Morgan as head of the firm's Islamic finance business. Mr Alam previously served as Calyon's director of Islamic banking, where he specialized in new product and internal organizational development, as well as client coverage. He had been with Calyon's Islamic banking unit since August 2005.

MERRILL LYNCH
Merrill Lynch has a new resident director for the Middle East. Jonty Crosse was chosen to lead the firm's global private client business team, reporting in to Eva Castillo.
Mr Crosse has been in Bahrain for 35 years, and joined Merrill Lynch in 1998 as a financial advisor. Throughout his tenure, he has played a key role in developing relationships in the region.

SOLIDARITY
Abdullah Sharif Al Rayes, Sayed Mohammad Jawad and Waleed Abdulla Hashim all received promotions.
Mr Al Rayes was appointed assistant general manager for Solidarity's general Takaful division, managing the division's operations in Qatar and Bahrain. Mr Al Rayes first joined Solidarity's general Takaful team as head of sales.

Mr Jawad will fill the role of assistant general manager for the finance and corporate management side, in addition to his role in IT and business development. He has been with Solidarity since its inception, in the IT department.

Waleed Abdulla Hashim will head the legal and compliance team as senior manager. Prior to joining Solidarity, Mr Hashim served a three- year tenure as a legal counsel for the Ministry of Finance.

SOLIDARITY
Sayed Jawad Mohamed Shubber, assistant general manager for information technology and business development at Solidarity, graduated from the Gulf Executive Development Program (GEDP).
Held at the Darden University of Virginia, US, the program is a four week residency involving case studies and projects to enhance executive skills and decision making.

UNION OF ARAB BANKS
Renowned banker Adnan Ahmed Yousif was elected as the chairman of the board of directors for the Union of Arab Banks, replacing Dr Joseph Tarabiah who had successfully completed his term.
Adnan, who is also the president and the chief executive officer of Albaraka Banking Group (ABG), will represent bankers in Bahrain for a three-year tenure. He has over 30 years' experience in international and Islamic banking and was a founding member of ABG.

ITHMAAR BANK
Ahmed A. Rahim is now Ithmaar Bank's new managing director for its Group Support division. He was previously Shamil Bank's general manager for Group Support, and has had 28 years' experience in the banking industry, namely at the National Bank of Bahrain (NBB).

Solidarity protects staff
Solidarity announced it would provide health insurance coverage for Batelco staff.

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News Briefs (continued...)

Rise in gross premiums
Statistics from the Central Bank of Bahrain showed a 22% rise in gross premiums for the Bahrain insurance sector in 2006, marking the strongest ever annual growth in recent years.

Insurance focus
Further advances were made in the insurance sector between the Central Bank of Bahrain and the Bahrain Insurance Association (BIA). A delegation from the BIA board, headed by its chairman, Ashraf Bseisu, met the Central Bank's deputy governor Anwar Al Saddah.

Employing Solidarity
Solidarity and the Bahrain Chapter of the Institute of Chartered Accountants of India (BCICAI) held a seminar on employee benefits and compensation Takaful/insurance.
Topics discussed included corporate savings schemes that offer a savings mechanism on a contributory basis with both employers and employees participating.

Don't stop me now!
It was suggested that the success of the Middle East insurance market would be judged by how fast local markets adapt to cashing in on opportunities. This can be achieved by surpassing stiff underwriting competition and attracting more human capital, as well as increasing professionalism, the Central Bank of Bahrain governor said.

Health assured
With the prospect of health insurance coverage becoming compulsory for expatriates in 2008, the Bahraini industry was bracing itself for this new development.

June

ARIG dips
The Arab Insurance Group (ARIG) saw profits dip for its first quarter of 2007 to US$7.6 million, from US$8 million in 2006. ARIG's Far East and Sub-Saharan Africa businesses raked in 10% gross premiums, reporting substantial growth despite the lack of consistency in inadequately priced accounts.

The bare necessities
In one of the largest ever insurance signings in the Gulf region, and the first of its kind in Bahrain, an agreement was arranged where Takaful International would insure all properties belonging to the Electricity and Water Ministry, amounting to BD1.6 billion (US$4.24 billion).

GIB upgraded
Gulf International Bank (GIB) received long and short-term foreign currency rating upgrades to A+ and A1 from A and A2, respectively from credit rating agency Capital Intelligence.

Confident of TAIB
TAIB Bank's long-term issuer default rating (IDR) of BB, short-term IDR of B and support rating of 5 was placed on Fitch Ratings' Rating Watch Positive, based on Dubai Financial's 60% acquisition of the bank, as well as steadier financials for TAIB with backing from the robust Dubai Holdings.

Misys solutions
Albaraka Banking Group finalized an agreement with Misys to utilize its Misys Equation Islamic core banking system.

Product agents
It was revealed that Shamil Bank would sell the Takaful products of Solidarity.

Previously known as KFI
Khaleej Finance and Investment (KFI) unveiled its new corporate identity – Capivest.

Less of the Khaleeji pie
Gulf Finance House (GFH) sold a 30% stake in Khaleeji Commercial Bank to a group of regional investors for an undisclosed value. GFH, previously sole owner of Khaleeji, increased the bank's paid-up capital by US$185 million to US$265 million, to widen its shareholder and client base.

Capital requirement amendments
The Central Bank of Bahrain proposed amendments to the capital requirements for foreign insurance firms operating in Bahrain. The proposed amendments would recognize any support from the banks' overseas parent companies, and would also state that overseas insurance firms need not maintain the same minimum as its capital. The branches would, however, need to maintain solvency margins as set by the CBB, which stood at BHD500,000 (US$1.3 million) for general insurance and BHD400,000 (US$1.06 million) for life insurance.

Sukuk Manafa'a up for listing
It was announced that the Golden Belt 1 Company's US$650 million Sukuk Manafa'a would list on the Bahrain Stock Exchange.

GFH's Sukuk plans
Gulf Finance House (GFH) revealed it aimed to raise US$300 million from Sukuk sales, having appointed Dresdner Kleinwort and HSBC as lead arrangers. GFH officials were confident that the five-year denominated bonds would be oversubscribed. The Sukuk is part of GFH's US$1 billion Shariah compliant medium-term notes program.

Global Banking Corporation
The Global Banking Corporation (GBCORP) was incorporated with a paid-up capital of US$250 million. GBCORP will focus on private equity and venture capital, real estate and infrastructure development, asset management, advisory services in corporate finance and capital markets and portfolio management services.

Massive oversubscription
The Central Bank of Bahrain's monthly Sukuk Ijarah was oversubscribed by 420%. Initially issued at BD5 million (US$13.26 million), CBB received subscriptions to over BD21 million (US$55.7 million). The Sukuk carries a 182-day maturity ending on the 27th December 2007.

Diyaar Sukuk
Diyaar Sukuk Company issued US$200 million in Sukuk Musharakah to finance the Diyaar Al Muharraq development, slated to be the largest real estate development project in Bahrain. The Sukuk, due in 2011, was arranged by Kuwait Finance House (KFH) and Norton Rose, which acted on behalf of KFH.

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News Briefs (continued...)

GIB stable
Gulf International Bank (GIB)'s long and short-term issuer default ratings were affirmed at A and F1 respectively. The bank gained an individual rating of C, along with a support rating of 1.

Preliminary Wakalah rating
Ithmaar Bank's Sukuk Wakalah was assigned a preliminary rating of BBB- by Standard & Poor's. The notes, due in 2012, are a result of Ithmaar Sukuk Company's investment management agreement with Ithmaar Bank.

Syndicated Wakalah
Awal Bank of Bahrain revealed it would set up a US$300 million syndicated Wakala restricted facility, conducted based on commodity Murabahah.

Successful exit for Unicorn
The Unicorn Global Private Equity Fund I saw a successful first exit from its major investment, Orimix Concrete Products. The fund sold a 40% stake in Orimix to a leading readymix concrete supplier in the UAE, garnering a return on investment of 36%.

Key to standardization?
The International Accounting Standards Board (IASB) approached several Bahraini companies to give their opinion on the new draft of the International Financial Reporting Standards (IFRS). Close to 100 countries have policies which converge with IFRS standards to some level, and the IASB is now beginning to see the crucial role of Islamic countries in the economy.

Prospectus published
Gulf Finance House (GFH) published a preliminary prospectus for its international offering of global depository receipts (GDRs). The GDR's had a price range of US$2.50 to US$3 per share, and US$25 to US$30 per GDR. Each GDR represented 10 shares, implying a value range of US$250 million to US$300 million upon offer.

Al Maraj plays host
Rasheed Mohammed Al Maraj, governor of the Central Bank of Bahrain, held talks with Robert Pickel, chief executive officer and executive director of the International Swaps and Derivatives Association (ISDA), and on a separate occasion, Rene Karsenti, executive president of the International Capital Market Association (ICMA). Al Maraj and Pickel discussed the joint master agreement between the ISDA and Islamic International Financial Market (IIFM). This agreement entails the documentation of privately negotiated Islamic derivatives transactions.

KFH Automall
Kuwait Finance House (KFH) opened the largest car showroom in Bahrain. Dubbed "Automall," the unit in Sitra offer insurance, financing and of course, cars.

BIsB cements agreement
Bahrain Islamic Bank (BIsB) signed a BD6.13 million (US$16.25 million) Ijarah Wa Iqtinah agreement with the Falcon Cement Company.

TAIB Bank controlled
Dubai Financial acquired a controlling 60% stake in TAIB Bank via a stock purchase agreement.

Bond success
The Central Bank of Bahrain's monthly Sukuk Al Salam issuance was oversubscribed by 133%. The initial BD6 million (US$15.91 million) issue received subscriptions worth BD8 million (US$21.21 million), and expects a 5.08% return upon maturity. The bonds carried a 91-day tenure.

Al Baraka crosses oceans
Bahrain-based Al Baraka Banking Group (ABG) revealed plans to expand into Indonesia via a representative office. The bank had received the regulatory approval necessary from Bank Indonesia.

First IIRA Shariah rating awarded
The Islamic International Rating Agency (IIRA) assigned Shariah quality ratings of AA to Syarikat Takaful Malaysia in its first ever Shariah quality rating. The rating was based on Takaful Malaysia's overall Shariah compliance, in terms of operations and business.

CBB confident
The Central Bank of Bahrain was confident of Bahrain's ability to meet investor demands for new funds. Rasheed Al Maraj, governor of CBB, emphasized the potential for funds in the region and called for greater alignment within the Islamic finance industry. Maraj also added that Bahrain is well placed to add to the US$9 billion of funds under management gathered from 2006.

Tadawul licensed
The Sukuk Exchange Center (Tadawul) received an operations license from the Central Bank of Bahrain. Tadawul has an authorized capital of BD500 million (US$1.32 billion) and a paid-up capital of BD300 million (US$795.67 million). The International Leasing Company of Kuwait is the company's main shareholder, with other shareholders comprising the Kuwait Investment Company, Qatar Islamic Bank and ICB, a subsidiary of the Islamic Development Bank. Shareholders chose to house Tadawul in Bahrain because of the country's strong footing in the Islamic industry.

The Arab-Russian Bank
Bahrain and Russia agreed to set up the Arab-Russian Bank, to be headquartered in Bahrain. The two countries will contribute equally to the bank's capital. The new bank will invest in real estate and energy projects.

INTERNATIONAL ISLAMIC FINANCIAL MARKET
Khalid Hamad, executive director of banking supervision at the Central Bank of Bahrain (CBB), was elected chairman of the International Islamic Financial Market (IIFM), while associate treasury director of the Islamic Development Bank (IDB), Mubarak Al Tayeb El Amin, was elected vice-chairman.

Both Mr Hamad and Mr Amin will serve three-year terms.

Solidarity serves better
Solidarity opened a new customer service center in the Reef Mall offering a diverse selection of Shariah compliant Family Takaful plans ranging from children's education, retirement, wealth accumulation and mortgage protection.

Takaful JV
Commerce Life Assurance, Commerce Takaful and Aviva signed an insurance joint venture.

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News Briefs (continued...)

The importance of Takaful
Solidarity and Labuan Re held a one-day Takaful workshop, focusing on Takaful and its influence on the industry.

July

British Musharakah
After a much publicized acquisition, The Investment Dar and Adeem Investment announced plans to sell Aston Martin in parts via a long-term Musharakah mainly to GCC investors.

BIsB profits
Bahrain Islamic Bank (BIsB) saw a 33% increase in profits to US$28.1 million in 2007 from US$21 million at the end of June 2006.

Islamic capital market boost
The International Islamic Financial Market (IIFM) and the International Capital Market Association (ICMA) concluded three meetings in Bahrain and London focusing on the development of international Islamic capital markets. The IIFM and ICMA were in the process of preparing detailed papers on the developments of the primary Sukuk market, and the market for Islamic repurchase agreements.

Emaar debt?
Emaar Properties and its subsidiaries were planning to borrow to pay for new projects, post-credit ratings.

Sukuk rated
Gulf Finance House (GFH's) US$1 billion Sukuk program (EMTN) was preliminarily rated BBB- by Standard & Poor's.

Oversubscribed yet again
The Central Bank of Bahrain's Sukuk Al Salam was oversubscribed by 200%. The initial BHD6 million (US$15.91 million) 91-day issue was oversubscribed to BHD12 million (US$31.8 million). The expected return on the issue of 5.08% commenced on the 4th July, and will mature on the 3rd October.

GFH names price
Initially set at a range between US$2.50 to US$3 per share, and US$25 to US$30 per global depositary receipt (GDR) for its US$276.5 million IPO, Gulf Finance House (GFH) settled on a US$2.50 price per share, and US$25 per GDR. 100 million shares were allocated for the international offering, with 10.6 million potentially available via an over-allotment.

Sakana goes halal
Sakana Holistic Housing Solutions implemented FLEXCUBE IT systems by i-flex solutions for its mortgage financing operations.

Roxar sold!
Arcapita Bank sold Roxar AS to Norway-based CorrOcean ASA for US$370 million.

NIG to raise money
The National Industries Group (NIG), Kuwait's largest construction materials firm by market value, planned to raise US$1.5 billion via Sukuk. Citibank, Standard Chartered and BNP Paribas were appointed arrangers.

GBCORP
Mark Hanson was chosen to head up the newly established Islamic bank GBCorp as chief executive. He has played a leading role in numerous large equity transactions including American Standard's US$200 million transaction, Red Sea Housing Services' US$140 million deal, and Arabian Shield Cooperative Insurance.

Mr Hanson was also an adviser to the Deputy Governor of the Saudi Arabian Monetary Agency (SAMA) and most recently head of corporate finance at the Saudi Hollandi Bank.

Hannover Re expands
Hannover Ruckversicherung AG (Hannover Re) announced it would be opening a new branch in Bahrain. Expected to commence business operations in early 2008, the branch will offer its clients both Shariah compliant and conventional insurance solutions from a single location.

Solidarity at the Automall
Solidarity opened a new customer service center at the KFH Automall. The center offers Family and General Takaful products, and is in line with Solidarity's Bahrain expansion plan.

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MIF2007 Issuers & Investors Forum

Dedicated to the Islamic finance industry in Malaysia, MIF is a growing brand. It was launched in early 2006 as a joint venture between the regulators of Malaysia, including the central bank, with the announcement of the inaugural MIF Issuers and Investors Forum.

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In the world of
Islamic Finance...

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