AAOIFI
JOIFA
Vol. 7 / Issue 1 / 2022

Peer-reviewed

An insight into financial benchmark reforms for Islamic finance

Editorial
- Need for reviewing Shari'ah-related aspects in Murabahah-based syndicated financing deals

Peer-reviewed
- Pakistan's Federal Shariat Court's judgment on Ribā: Lesson for transforming the economy and reforming the Islamic finance industry

Technical article
- Islamic finance: Potential for accommodating ESG as an additional layer of governance


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AAOIFI´s technical bulletin

JOIFA is interested in publishing original theoretical or empirical research papers in English, reports from conferences and symposiums, developments in the field of Islamic accounting and related areas including auditing, Shari'ah auditing, governance, tax, corporate laws, ethics etc., (collectively mentioned as accountancy) and book reviews, as well as, documents and archives related to Islamic finance accountancy.

Message

AAOIFI Update

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بسم الله الرحمن الرحيم

Message of Mr. Omar Mustafa Ansari

Secretary General, AAOIFI

Mr. Omar Mustafa Ansari
Secretary General, AAOIFI

It gives me great pleasure to welcome you to this issue of JOIFA.

As the world is almost out of the pandemic and life is settling back to normal, ample opportunities and challenges lie ahead of us. Islamic finance industry has moved far ahead since its modest beginnings and we can say that the market has a reasonably good understanding in terms of what value proposition the industry has to offer to the society at large. The trends suggest that certain jurisdictions have advocated the conversion of their commercial banks into Islamic ones, and move towards interest-free system, while certain others have sought to venture into the Islamic finance domain more vigorously than seen in the past.

One recent example is that of Pakistan where the Federal Shariat Court (FSC) declared in April this year that Riba in all its forms including the modern-day banking interest is prohibited and directed that the system based on interest must be replaced within five years. This issue of JOIFA provides an analysis of the FSC judgment and suggests the way forward.

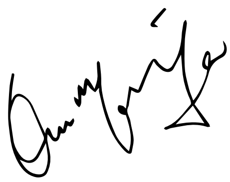
This issue of JOIFA also touches upon aspects of alternative benchmark rates which provide an insight into the financial benchmark reforms for Islamic finance, whereby AAOIFI has formed a working group to develop and issue a governance standard on "Development and Governance of Shari›ah Compliant Benchmark Rates". One of the burning topics for accommodating ESG as an additional layer of governance from Islamic perspectives, its potential and role of regulators and Shari›ah scholars, and insights on how Islamic finance stakeholders can take a lead to harness its potential is also discussed in the technical papers section.

As Islamic finance take-up increases, predominantly in African and Far East regions, AAOIFI and other stakeholders have a considerable role to play in instilling confidence in these newer markets, and ensuring that the industry is grounded with the inherent principles of Shari›ah and Islamic finance. On behalf of AAOIFI let me take this opportunity to assure you of all the support the industry needs to develop within the mandate of AAOIFI, and also express my sense of gratitude to all the stakeholders of AAOIFI for their support and guidance.

We encourage you to continue sending your research work and technical articles to the JOIFA editor. We will endeavour to publish them with the due review process and relevancy within the scope of JOIFA and AAOIFI's mandate. It must be noted that research work and the ideas published in JOIFA directly feeds into the standards development process of AAOIFI.

We are appreciative of the constructive feedback and professionalism of our reviewers who ensure that material published in JOIFA is insightful, authentic and market pertinent, and also of those experts and stakeholder who support the cause of AAOIFI to be the guiding force for the development of Islamic finance industry.

As always, we wish you an insightful read of this issue of JOIFA.



AAOIFI technical boards' update

AAOIFI Shari'ah Board

AAOIFI issued Shari'ah standard on Sale of debt in English

The AAOIFI Shari'ah Standards Translation Committee has finalised and approved the issuance of the English version of Shari'ah Standard 59 "Sale of Debt". The translation committee made a considerable effort in selecting the most appropriate technical and legal terminologies in order to present an accurate version of the standard to the Islamic financial industry. The standard can be accessed from the AAOIFI website.

AAOIFI published latest and updated edition of AAOIFI Shari'ah Standards book

AAOIFI has published the latest edition of the Shari'ah Standards book covering standards 1-61 in the Arabic language. The edition contains all AAOIFI Shari'ah Standards approved until Jumada al-Akhirah 1443 AH - January 2022 AD. The latest book was launched at the AAOIFI Shari'ah Boards Conference held on 15-16 May 2022 in Bahrain. The book is available for download from the AAOIFI website.

AAOIFI Shari'ah Board work-in-progress projects

- Agricultural participations and their contemporary applications
- Build operate transfer contract (BOT)
- Conversion of a conventional bank to an Islamic bank
- Fees and commissions
- Financial custody
- Ijarah and Ijarah Muntahia Bittamleek
- Ijarah Mousufa Bil Dhimma
- Khayrat account
- Ownership risk in financing formats
- Special purpose vehicle (SPV)
- Sukuk

Meetings summary

Various meetings were held to discuss the above Shari'ah standards in progress physically in Bahrain, Madina al Munnawara, and Riyadh, and over Zoom. Cumulatively 27 days were spent these meetings.

Shari'ah Board meetings	9
Shari'ah standard committees meeting(s)	1
Shari'ah basis committee meetings	2

AAOIFI Accounting Board (AAB)

AAOIFI in-principle approved FAS 41 "Interim Financial Reporting"

AAOIFI Accounting Board (AAB) finalised Financial Accounting Standard (FAS) 41 "Interim Financial Reporting". The standard aims to set out the principles for interim financial reporting for all institutions (including virtual entities) that have adopted AAOIFI FASs. This standard should be read with other AAOIFI FASs and generally accepted accounting principles, applicable in respective jurisdictions.

AAOIFI approved exposure draft on off-balance sheet assets under management

AAB approved exposure draft of its standard "Off-Balance-Sheet Assets Under Management" This standard aims to establish the principles of financial reporting related to off-balance-sheet assets under management in line with the AAOIFI Conceptual Framework for Financial Reporting (the conceptual framework).

AAOIFI approved exposure draft of FAS on "Control"

AAB approved for issuance the exposure draft of FAS on "Control". The standard on Control aims to establish the principles of assessing as to whether and when an institution controls an asset or a business and shall be applicable to all institutions preparing financial statements in line with the requirements of FASs and Shari'ah compliant transactions. The review process entailed discussion on recommendations received from the respective working group. Accordingly, the draft was approved for issuance in the light of suggested changes.

AAOIFI issued FAS 30 "Impairment, Credit Losses and Onerous Commitments" in Arabic

AAOIFI's Accounting Board (AAB) Translation Committee approved the issuance of the Arabic version of Financial Accounting Standard (FAS) 30 "Impairment, Credit Losses and Onerous Commitments", The English version of this standard was issued on 22 November 2017 and became effective for the financial periods beginning on or after 1 January 2020.

This standard is aimed at setting out the accounting rules and principles for impairment and credit losses, covering current and expected losses, in line with global best practices, taking into account the ever-changing requirements and the genuine requirements of the Islamic finance industry across the globe. It also sets out classification of assets and exposures in view of the credit risk and other risks involved. The idea is to apply the forward-looking approach in line with other standard setters for the assets and instruments that are financial instruments from Shari'ah perspective and to define other globally acceptable impairment and write down and provisioning approaches for other assets and exposures, without compromising on Shari'ah. It further covers the situations where onerous commitments exist which mandate a provision for anticipated losses on the same.

AAOIFI issued FAS 35 "Risk Reserves" in Arabic

The standard provides principle-based guidance on maintaining reserves, including the approach for maintaining and utilizing reserves. The standard require IFIs to disclose in the financial statements the basis for determining the transfers in and out of reserves, thresholds for specific reserves and the use of specific reserves. Moreover, it provides guidance for assessment and accounting for various risks involved, and recognize the need for varying levels of reserves in line with the dynamism of risks across the financial calendar. It also creates a link between the allowances for impairment, credit losses and onerous commitments against the reserves to be maintained for the participating stakeholders. This standard became effective for the financial periods beginning on or after 1 January 2021.

AAOIFI issued FAS 39 "Financial Reporting for Zakah" in Arabic

AAB Translation Committee finalised and approved the issuance of the Arabic version of Financial Accounting Standard (FAS) 39 "Financial Reporting for Zakah", the English version of this standard was issued on 31 December 2021 and is effective for the financial periods beginning on or after 1 January 2023.

This standard improves upon and supersedes AAOIFI Financial Accounting Standard (FAS) 9 "Zakah" issued previously. This standard aims at setting out the accounting treatment of Zakah in the books of an Islamic financial institution, including the presentation and disclosure in its financial statements.

The standard describes the financial reporting principles applicable, depending upon the institution's obligation to pay Zakah. In addition, where an institution is not required by law or by virtue of its constitution documents to pay Zakah, it is still required to identify and disclose the amount of Zakah due in respect of the various stakeholders.

AAB defers effective date of FAS 1 to January 2024

AAB in its 29th meeting on 25-26 September 2022 deliberated on the feedback received from certain Islamic financial institutions operating in various markets on the potential constraints in adopting and implementing the recently issued Financial Accounting Standards (FASs). The board acknowledged that the institutions are facing certain practical difficulties in making the necessary procedural shift in their financial reporting requirements, specifically in terms of preparation of financial statements (considering non-availability of illustrative financial statements), changes in accounting policies and corresponding modifications in the accounting and IT systems. Accordingly, the board decided to defer the effective date of the recently issued AAOIFI FAS 1 "General Presentation and Disclosures in the Financial Statements" from 1 January 2023 to

1 January 2024. It also concluded that that early adoption of the standard shall be encouraged.

AAOIFI Technical Advisory and Interpretation Committee (TAIC) intends to issue a Technical Release for facilitating the implementation of new AAOIFI FASs, namely "AAOIFI Illustrative Financial Statements for Islamic Banks and Similar Institutions".

1. Update on AAOIFI Accounting Board (AAB) and other meetings

Board meetings	Final standard(s) (approved in-principle)	Public hearing(s)/ round table(s)/ Focus group(s)	Working group meeting(s)	Translation committee meeting(s)	Short working group / executive team meeting(s)	Project(s) in pipeline	Shari'ah committee meetings
03	01	07+02+01	15	26	29+	10+	4

2. Standard(s) exposure drafts issued / approved for issuance

- Final standards

- FAS 41 "Interim Financial Reporting" (approved - to be issued)
- FAS 42 "Presentation and Disclosures in the Financial Statements of Takaful Institutions" (approved - to be issued)
- FAS 43 "Recognition and Measurement in the Financial Statements of Takaful Institutions" (on agenda for board approval in November 2022)

- Exposure draft(s) approved for issuance

- [ED of] "Quasi-Equity (including investment accounts)"
- [ED of] "Control"
- [ED of] "Off-Balance-Sheet Assets Under Management"

3. Projects in pipeline/ work-in-process

- FAS 1 illustrative financial statements (advanced stage)
- Zakah computational guidelines for Islamic finance institutions (review stage)
- Waqf illustrative financial statements
- Accounting for Hyperinflationary Economies
- Gifts and Prizes
- Alternative Benchmark Rate
- Integrated Reporting
- Tawarruq and commodity Murabaha
- Revision of FAS 3 "Mudaraba Financing" and FAS 4 "Musharaka Financing"
- Revision of FAS 21 "Disclosure on Transfer of Assets"
- Revision of FAS 7 "Salam and Parallel Salam" and FAS 10 "Istisnaa and Parallel Istisnaa"
- FAS 29 "Sukuk in the Books of the Originator" (to be reissued as exposure draft)

4. Public hearings and roundtable on exposure drafts

Exposure draft(s)	Event mode	Date
AAOIFI FAS on Takaful roundtable	Regulators and expert webinar	21-Feb-22
[ED of] "Interim Financial Reporting"	Webinar in Arabic	28-Feb-22
FAS 1 illustrative financial statements	Expert round table	10-Mar-22
[ED of] "Accounting for Takaful: Recognition and Measurement"	Webinar in English	24-Mar-22
[ED of] "Accounting for Takaful: Recognition and Measurement"	Webinar in English	25-Jul-22
[ED of] "Accounting for Takaful: Recognition and Measurement"	Webinar in Arabic	10-Aug-22
[ED of] "Presentation and Disclosures in the Financial Statements of Takaful Institutions"	Webinar	24-Mar-22
ED of] "Presentation and Disclosures in the Financial Statements of Takaful Institutions"	Webinar in English	25-Jul-22
ED of] "Presentation and Disclosures in the Financial Statements of Takaful Institutions"	Webinar in Arabic	10-Aug-22

Standards issued available on AAOIFI website

- FAS 36 "First Time Adoption of AAOIFI Financial Accounting Standards" (Projects in pipeline)
- FAS 37 "Financial reporting by Waqf institutions"
- FAS 38 "Wa'ad, Khiyar and Tahawwut"
- FAS 39 "Financial Reporting for Zakah"

Standards issued as exposure drafts available on AAOIFI website

- [ED of] "Financial Reporting for Zakah"
- [ED of] "Financial Reporting for Islamic Financial Services Offered by Conventional Financial Institutions"
- [ED of] "Interim Financial Reporting"
- [ED of] "Presentation and Disclosures in the Financial Statements of Takaful Institutions"
- [ED of] "Accounting for Takaful: Recognition and Measurement"

AAOIFI Governance and Ethics Board (AGEB)

AAOIFI and IFSB issued exposure draft of IFSB-AAOIFI Revised Shari'ah Governance Framework for Institutions Offering Islamic Financial Services (RSGF)

AAOIFI Govenance and Ethics Board (AGEB) issued the exposure draft of IFSB-AAOIFI Revised Shari'ah Governance Framework for Institutions Offering Islamic Financial Services (RSGF). The RSGF is a collaboration between AAOIFI and IFSB that aims to provide a revised set of guiding principles and rules on the key components of a sound and effective Shari'ah governance framework for Islamic financial institutions (IFIs).

The issued RSGF exposure draft discusses fourteen principles of Shari'ah governance framework: Shari'ah governance framework, role of regulatory and supervisory authorities, central Shari'ah board, unique organs of institutional Shari'ah governance framework, role of the board of directors and senior management, Shari'ah supervisory board, Shari'ah compliance function, Internal Shari'ah audit function, independent external Shari'ah audit, Islamic windows, Islamic subsidiaries / affiliates, other considerations, applicability to different sectors as well as disclosure and transparency.

The standard seeks to combine the efforts of the two Islamic standard setting bodies to provide consistent and harmonised Shari'ah governance guidelines for different stakeholders.

AAOIFI approved exposure draft of governance standard "Shari'ah Compliance and Fiduciary Ratings of Sukuk and Other Islamic Finance Instruments"

AGEB in its 24th meeting approved in-principle the exposure draft of governance standard "Shari'ah Compliance and Fiduciary Rating of Sukuk and Other Islamic Finance Instruments". The exposure draft aims to introduce and set out principle-based guidance on Shari'ah compliance and fiduciary ratings of Sukuk and other Islamic finance instruments.

Furthermore, the exposure draft seeks to strengthen stakeholders' confidence in the Islamic finance industry and the Islamic capital markets as well as improve transparency and demonstrate the compliance of Sukuk and other Islamic finance instruments with the standards, regulations and best practices related to Shari'ah principles and rules, Shari'ah governance, adherence to values and fiduciary responsibilities.

AAOIFI in-principle approved exposure draft of a governance standard "development and governance of Shari'ah compliant benchmark rates"

AGEB in its 25th meeting approved in-principle the exposure draft of governance standard "development and governance of Shari'ah compliant benchmark rates". The exposure draft aims to provide principles for the need, development, suitability criteria for and use of benchmark rates for Islamic financial transactions and structures, in a manner that these rates are transparent and Shari'ah compliant and can provide alternatives for LIBOR and other conventional benchmark rates, including risk free rates (RFRs).

AAOIFI and the IFSB issued exposure draft of their joint standard on RSGF in Arabic

The translation committee of AGEB approved the issuance of the Arabic version of the exposure draft of the joint standard "IFSB-AAOIFI Revised Shari'ah Governance Framework for Institutions Offering Islamic Financial Services". The English version of this standard was issued previously. AAOIFI completed the Arabic translation of the exposure draft through its approved mechanism, which comprises several phases aimed at ensuring the quality and accuracy of the translation. The mechanism included the initial translation, a high-level review of concepts and terminologies by AAOIFI secretariat, the proofreading phase through individual reviews and a series of meetings held by the assigned committee. The translation committee includes ten experts who combine deep knowledge of the English and Arabic languages, with Shari'ah expertise, and banking and legal background.

AAOIFI issued exposure draft of governance standard on "Syndicated Financing" in Arabic

AGEB issued the Arabic translation of the governance standard (GS) "Syndicated Financing" after following its technical and professional mechanism of translation. Such a mechanism comprises various phases aimed at ensuring the issuance of top-quality translation and providing the standard to the widest possible audience.

AGEB translation committee has the responsibility of conducting a detailed review of the final standard once it is approved and issued by AGEB.

AAOIFI issued the exposure draft of governance standard on "Islamic crowdfunding " exposure draft in Arabic

AAOIFI issued Arabic version of the exposure draft of governance standard "Islamic crowdfunding". As a matter of AGEB policy, the exposure drafts and standards related to governance, audit and ethics are drafted and issued in English. However, AAOIFI in order to cater to the request of the industry at large takes it upon itself to develop the Arabic versions of the standards through a due process of quality translation.

Standards issued as exposure drafts available on AAOIFI website

- Revised Shari'ah Governance Framework for Institutions Offering Islamic Financial Services
- Islamic crowdfunding governance (Arabic)
- Syndicated financing (Arabic)

Exposure drafts approved in-principle

- Shari'ah Compliance and Fiduciary Ratings of Sukuk and Other Islamic Finance Instruments
- Development and governance of Shari'ah compliant benchmark rates
- Shari'ah decision making (SDM) process

1. Updates on AGEB and working groups

Board meeting(s)	Exposure draft(s) issued	Exposure draft approved in principle	Public hearing(s) and roundtable(s)	Shari'ah committee meeting(s)	Translation committee meeting(s)	Working group / Short working group	Professional Auditing Standard Committee (PASC)	Projects in development	Projects in pipeline
4 (7 days)	3 (1 in Eng and 2 in AR)	3	10+2	3 (4 days)	3	18/ 40	3	13	10

2. AGEB public hearings and roundtables

Standards	Languages	Country / Venue	Date
Development and governance of Shari'ah compliant benchmark rates	English	Roundtable webinar	18 January 2022
Islamic crowdfunding	English	Public hearing webinar	31 January 2022
	Arabic	Public hearing webinar	22 August 2022
	English	Public hearing webinar	23 August 2022

Syndicated financing	English	Public hearing webinar	31 January 2022
	English	Public hearing webinar	8 September 2022
	English	Public hearing webinar	18 October 2022
	Arabic	Public hearing webinar	27 October 2022
IFSB-AAOIFI revised Shari'ah governance framework for institutions offering Islamic financial institutions (RSGF)	English	Public hearing webinar	11 May 2022
			20 June 2022
	Arabic	Public hearing webinar	15 June 2022
	English	Roundtable webinar	16 June 2022

3. Standards in development and in pipeline

Standards in development	Standards in pipeline
• Shari'ah decision making • Internal Shari'ah audit guidelines • External Shari'ah audit guidelines • Islamic crowdfunding • Shari'ah compliance and fiduciary rating of Sukuk and other Islamic finance instruments • Governance standard on institutional framework for implementation of code of ethics • IFSB-AAOIFI revised Shari'ah governance framework for institutions offering Islamic financial institutions (RSGF) • Review of the auditing standards • Development and governance of Shari'ah compliant benchmark rates • Syndicated financing • Sustainable financing • Management for investment accounts • Tawarruq / Commodity Murabaha	• Zakah Governance • Fintech • Digital Banking • Smarts Contracts • Special consideration standard on Islamic windows governance • Special consideration standard on Takaful governance • Special consideration standard on mutual funds governance • Small and Medium-sized Enterprises (SMEs) & Micro Enterprises • Governance standards on annual reports • Ethics handbook

AAOIFI conferences and events

AAOIFI successfully concludes the 20th AAOIFI Annual Shari'ah Boards Conference

AAOIFI hosted 20th AAOIFI Annual Shari'ah Boards Conference in Bahrain. The two-day conference organised under the patronage of the Central Bank of Bahrain (CBB) on 15-16 May 2022 received more than 400 delegates from no less than 20 countries from around the world and more than 600 delegates virtually.

Thirty-five speakers and experts were part of the six panel discussions. The chief guests at the conference included the chairman of AAOIFI Shari'ah Board, Sheikh Mufti Muhammad Taqi Usmani, Governor of Central Bank of Bahrain, H.E. Rasheed Mohamed Al Maraj; Governor of Palestine Monetary Authority, H.E. Dr. Feras Milhem and chairman of Libyan Capital Market Authority (LCMA), H.E. Mahmoud Mohamed Wafa. The speakers included Shari'ah scholars, policymakers, bankers, services providers from the global Islamic banking and finance industry who discussed various pressing topics in detail.

Accordingly, the resolutions of the conference will be shared in due course.

The 20th edition of the conference was supported by Saudi National Bank (SNB) from Kingdom of Saudi Arabia, Jumhouria Bank from Libya, and Kuwait Finance House. In addition, Al Salam Bank, Bahrain; Abu Dhabi Islamic Bank (ADIB), UAE; Al Baraka Banking Group, Jordan Islamic Bank and IFIN supported the conference. AAOIFI also signed important partnership agreements at the conference with a number of institutions to strengthen its footprint and to collaborate with them on various fronts for the benefit of the industry.

Updates on capacity building

AAOIFI conducted series of online technical workshops and capacity building programmes

AAOIFI conducted a series of online technical workshops covering areas of standard-setting: Shari'ah, accounting, auditing, governance and ethics as part of building industry capacity for Islamic finance professionals. The workshops were attended by participants from around the global who received more hours of training based on lectures, comprehensive case studies, concept checkers, MCQ-style online quizzes, brainteasers, group activities, and Q&A. The workshops were led by the Secretary General, members of the AAOIFI technical boards and education board (AEB) as well as by the head of capacity building programs and AAOIFI master trainers.

#	Workshop	Mode	Language	No. of days	Starting date
1	AAOIFI requirements for Ijara	Online	English	2	14-March
2	AAOIFI requirements for Murabaha	Online	English	2	20-March
3	AAOIFI requirements for participatory equity-based contracts	Online	English	4	28-March
4	In partnership with IFSB for NAICOM, Nigeria, workshop on Takaful	Physical	English	3	29-March
5	In partnership with CIBAFI: Mastering ethical requirements for Islamic finance professional	Online	Arabic	2	30-May
6	Mastering Islamic risk management and hedging, in line with AAOIFI standards	Online	English	4	05-June
7	Mastering deposit pool management and profit and loss distribution mechanism at Islamic banks (w/ computational exercises)	Online	English	4	26-September
8	In partnership with Da Afghanistan Bank (central bank) workshop on conversion of a conventional bank to an Islamic bank	Online	English	4	10 October

AAOIFI concluded 8th meeting of the AAOIFI Education Board (AEB)

AAOIFI concluded the 8th meeting of the AAOIFI Education Board (AEB) on 12 September 2022. The AEB is the governance arm of the capacity building initiatives and activities of AAOIFI which performs its role through the three subcommittees it formed, namely: the curriculum review committee (CRC); the examinations review committee (ERC); and the translations review committee (TRC), respectively.

Update on subcommittee meetings of AAOIFI Education Board

#	Description	Total	CRC	ERC	TRC
1	No. of committee meetings since inception	10	3	4	3
2	No. of working groups established	22	10	6 (in process)	6 (in process)
3	No. of members of the different working groups	61	25	Min. 18	Min. 18
4	No. of working group meetings since inception	45	45	-	-
5	No. of external consultants working on different projects	16	5	9	2

Update on projects in pipeline and work-in-process

- 30% of the work completed on CIPA E-learning project;
- CIPA curriculum – first draft of all four study texts have been finalized. Being reviewed by the working groups and subcommittees of AEB;
- CIPA Russian translation – first draft completed. Review process to be started by the working group of the Translation Review Committee (TRC) which is a subcommittee of AEB;
- CSAA revamping project – consultant has submitted the first draft of all 8 modules of the respective Certified Shari'ah Advisor (CSAd) and Certified Shari'ah Auditor programs (CSAu); and
- AAOIFI Certificate of Proficiency in Financial Accounting Standards (CPFAS) lanched in February 2022. Registrations are open.

Strategic relationships

AAOIFI held strategic meetings with FRA and stakeholders in Egypt, held 29th AAB meeting

AAOIFI delegation headed by the Secretary General, Mr. Omar Mustafa Ansari, and the Chairman of AAOIFI Accounting Board (AAB), Mr. Hamad Oqab held a series of strategic meetings with key market stakeholders in Egypt. During the visit, the AAB's 29th meeting was also held on 25-26 September 2022. The meeting was supported and facilitated by Abu Dhabi Islamic Bank (ADIB)-Egypt and the Egyptian Islamic Finance Association (EIFA).

The visit witnessed several meetings including with Dr. Islam Azzam, Vice Chairman, Financial Regulatory Authority of Egypt (FRA), ADIB-Egypt's senior management including Mr. Mohammed Ali, Chief Executive Officer and other officials; Sarwa Capital; Aman Financial Services and Egyptian Microfinance Company – Maksab.

AAOIFI also participated in a conference co-organised by the Arab Administrative Development Organisation, League of Arab States and EIFA where Mr. Ansari delivered a keynote presentation on "Challenges for Governance of Financial Technology".

AAOIFI held strategic meetings with regulators and stakeholders in Türkiye, also held 29th AGEB meeting and public hearing

AAOIFI delegation headed by the Secretary General of AAOIFI and the Chairman of the AAOIFI Governance and Ethics Board (AGEB), held multiple strategic meetings with important regulatory and supervisory institutions, as well as with other stakeholders in Istanbul, Türkiye. The visit was supported and facilitated by Participation Banks Association of Türkiye (TKBB).

The delegation held meetings with the Banking Regulation and Supervision Agency (BRSA – BDDK), the Presidency of the Republic of Türkiye Finance Office (CBFO), Central Bank of the Republic of Türkiye (CBRT) and Insurance and Private Pension Regulation and Supervision Agency (IPRSA – SEDDK). The meetings were aimed at strengthening strategic ties on areas of mutual interest between AAOIFI and the key stakeholders in Türkiye. The meetings also addressed initiatives to cater to the need and interest to develop participation finance industry in Türkiye and to foster harmonisation of standards and practises with the Turkish counterparts. AAOIFI Financial Accounting Standards (FAS) are already translated in Turkish language. As part of the visit AAOIFI also conducted a public hearing of its exposure draft on “Syndicated Financing” and held 27th meeting of its AAOIFI Governance and Ethics Board (AGEB) at the TKBB premises in Istanbul, Türkiye.

AAOIFI signed key strategic partnerships at 20th Shari'ah Boards Conference

AAOIFI signed memoranda of understanding (MOUs) and AAOIFI membership agreements on the side-lines of its 20th Shari'ah Boards Conference. The MOUs signed at the conference held on 15-16 May 2022 in the Kingdom of Bahrain, aim to strengthen mutual ties not only between the institutions but also to cater to the growing need and interest to develop Islamic finance industry in their respective jurisdictions.

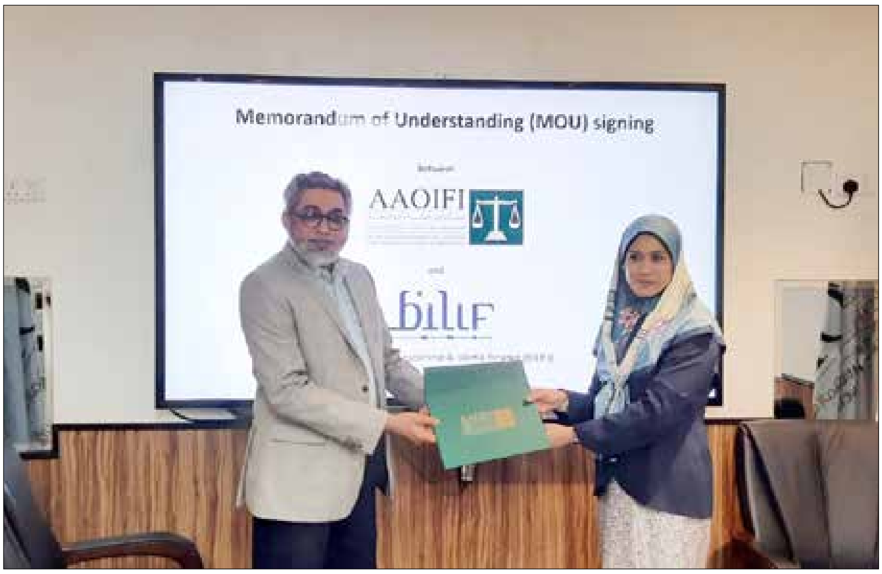
The first MOU was signed with Sharjah Center for Islamic Economics at Al Qasimia University. The agreement is intended to support training, professional development and technical research in areas related to the Islamic finance, as well as cooperation in organizing and sponsoring conferences, seminars, workshops, and related to Islamic economics and finance, its developments and practices.

The second MOU was entered into with the Insurance and Private Pension Regulation and Supervision Authority (IPRSA) (Sigortacılık ve Özel Emeklilik Düzenleme ve Denetleme Kurumu (SEDDK). AAOIFI Membership agreement was also signed with IPRSA at the confernece. AAOIFI also signed Candidate Registration Centre agreement with Islamic Business and Finance LLC of Uzbekistan.

Additionally, AAOIFI also inked an MOU with the Brunei Institute of Leadership and Islamic Finance (BILIF) at a separate ceremony held at AAOIFI headquarters.

AAOIFI signed MoU with Kazan Federal University at Kazan Summit sidelines

AAOIFI participated in the Kazan Summit 2022 which took place on 19-21 May 2022 in Kazan, Tatarstan, Russian Federation. On the occasion, AAOIFI signed an MOU with the Kazan Federal University to develop and implement academic mobility programmes; establish and broaden collaboration between teaching and research staff and students; conduct joint research projects, organise academic courses / programs, seminars, conferences, and exchange knowledge under multiple conduits, among others. The agreement will enter into force upon ratification by the Ministry of Science and Higher Education of the Russian Federation and shall be valid for a period of five years. It may be noted that AAOIFI offers training programmes in Russian language and has recently completed the translation of its CIPA and CSAA modules in Russian.



Other initiatives

AAOIFI embarks on digital transformation and process-automation initiative

AAOIFI in order to leverage various technologies, applications and services plans to fully digitalize and automate its internal and external operations and processes. This digital transformation exercise is part of the AAOIFI's push to achieve operational efficiency and optimum resource utilization for enhanced value offering.

AAOIFI enlisted the support of Lyst Technologies (LYST) for the successful design, development and implementation of the digital transformation strategy of AAOIFI, which includes, besides other projects, the following key projects: implementation of the enterprise resource planning (ERP) and customer relationship management (CRM) solutions; online payment gateway; process automation of the capacity building services of AAOIFI; and development of an AAOIFI website, online portal for Journal of Islamic Finance Accountancy (JOIFA) and smart apps. Under the arrangement, LYST will digitally transform and automate all AAOIFI operations and processes using state-of-the-art technologies and solutions within a period of one year.

Editorial

Need for reviewing Shariah-related aspects in Murabahah-based syndicated financing deals

Muhammad Ayub[1]

The use of syndicated financing structures by Islamic financial institutions (IFIs) has flourished over the last two decades. It facilitates both the participating IFIs and clients needing funds alike in large-value financing for short and medium-terms. The lead bank coordinates the process of preparing and finalizing the documentation and closing the deal.

Murabaha syndications and deals have in the past been concluded in Malaysia, Saudi Arabia, Bahrain, Turkey, the UAE, and other markets. The funds raised from the syndicate group are used to finance a wide range of activities including, among others, financing high value clients, expansion of a REIT, petrochemical plant activities, purchase of machinery and other assets, telecoms expansion, the securitization of any earlier non-asset backed securitization transaction and refinancing existing debt[2]. Murabaha-based syndications also flourished as a complement to Sukuk as a diversified source of financing. For instance, a Saudi-based bank recently entered into a medium-term dual tranche sustainability Commodity Murabaha facility with a total amount exceeding US$1.0 billion. The proceeds from the syndication were meant to be allocated to Sharia-compliant and sustainable projects to comply with the Green Loan Principles (GLP), Social Loan Principles (SLP), environment friendly Green Bond Principles (GBP), Social Bond Principles (SBP), and Sustainability Bond Guidelines (SBG)[3].

Generally, there are two tiers to a typical Islamic syndicated finance transaction. Tier-1 defines the relationship between the participating financial institutions (FIs) and the lead bank, while tier-2 defines the structure of the financing to the customer by the lead bank. For tier-1 in an Islamic syndication, the contracts generally used are Wakālah or Mudarabah, meaning that the relationship between the participating FIs and the lead bank is based on Wakālah against any fee, or on sharing in profit / loss as per the principle of Mudarabah. However, the Islamic financial industry has increasingly adopted Wakālah as opposed to the Mudarabah structure[4].

For tier-2, i.e., for financing the clients, all Islamic modes of financing can be used, but one of the most used structures is that of organized Tawarruq that is juristically based on the principles relating to credit Murābahah. This is because this structure resembles conventional financing to a great extent and does not involve sale of any assets to the banks for the purpose of leasing. However, to fulfill Sharī'ah compliance requirements, the principles of Murābaha including those related to possession and delivery of the underlying goods and receivables / payables have to be complied with. Presented with increasing evidence of general non-compliance with these principles by IFIs, the Jeddah-based Islamic Fiqh Council (IFC) resolved in 2009 that 'organized tawarruq', as practiced by many banks and financial institutions, was not

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2- https://www.ddcap.com/murabaha-syndications-and-transactions-proliferate-with-sr12-133-billion-of-deals-in-saudi-arabia-in-june-2019-alone/

3- https://www.alrajhibank.com.sa/en/About-alrajhi-bank/Media-Center/2022/The-success-of-over-a-billion-dollar-sustainable-financing-for-alrajhi-bank [AL Rajhi's Press Releases, 20/09/2022]

4- Riza Ismail (March, 2012) https://www.tamimi.com/law-update-articles/islamic-syndicated-finance/ [First, published in Islamic Finance News, Volume 7 Issue 30].

permissible. “It comprised merely the paper deals disguising the elements of interest-based lending”, the IFC remarked.

However, many Shari’ah scholars associated with IFIs permitted the continuing use of Tawarruq as a means of financing, provided that there were proper checks and balances to prevent its use as a fictitious transaction. The AAOIFI’s Shari’ah standard 30 on Tawarruq (Monetization) provides for such checks and balances and allows Tawarruq with certain conditions and firewalls[5]. For this editorial, we focus on the principles governing the receivables / payables accruing from the credit deals with tier-2 clients in a syndicated Murabaha financing facility. In other words, it pertains to the rules of debt that have been described in the AAOIFI Shari’ah Standard 59 “Sale of Debt”, issued in 2019.

According to the credit Murābaha principles, the price once agreed between the parties, and so the receivable / payable in the currency of the Murābaha deal, cannot be increased, which is why Murābaha is typically used for short-term financing only. However, as syndicated Murābaha facilities started to be used for medium-term periods such as 3, 4, or 5 years, the lead arrangers and participant banks in such facilities tried to hedge their receivables in terms of US dollars or any other reserve currency to mitigate against exchange rate risk. In principle, any such provision is not allowed as per clause 8/2 of AAOIFI Shari’ah Standard 24 “Syndicated Financing”[6]. To circumvent this prohibition, some IFIs have developed a novel solution, where a new Murābahah is executed to settle the receivables of the previous Murābaha. This may be considered valid provided that a genuine new trade / sale is executed, rather than a notional transaction with no new disbursement. Further, all Shari’ah requirements related to the subject matter, its handing-over to the buyer, and the requirements regarding the receivables should be fulfilled in a manner that would keep both the transactions completely segregated and independent from each other.

More recently, some banks have come up with another innovation to achieve a variable rate of return from Murabahah, where they bifurcate a single Murabaha into two legs, one for the long term with the margin rate and then a series of short term Murabaha transactions on the back of a purchase undertaking from the client to get the variable rate based on an agreed benchmark. In our opinion, this structure does not fulfill Sharī’ah compliance requirements as per AAOIFI Sharī’ah standards, and gives rise to the following issues:

For all practical intents and purposes, the second Murābahah is not separate and independent from the first; the two transactions are inter-linked and inter-dependent. No bank is ready to finance a customer with a profit comprising the benchmark or the margin only. Consequently, the second Murābahah acts like the second leg of a single transaction, bringing the structure in direct violation of clause 4/1/3/4 of Sharī’ah standard 59 on bai al dayn.

There is no new credit approval for the second Murābahah transaction (in violation of clause 4/1/3/4 of SS 59) which implies that it is in fact a notional transaction where funds are not actually disbursed.

Further, in many cases, the client cannot put his hands on the goods, or their sale proceeds directly as they incorporate a mechanism to ensure payment of the liabilities under the first Murābahah through the appointment of a “Sale agent” who is required to act as per the satisfaction of the financing banks, or their investment agent, and not as the agent of the client (the Murābahah purchaser in this case). The sale agent deducts all the receivables of the bank before paying the remaining proceeds to the investment agent of the banks for depositing into the client’s account. The appointment of any financing bank, or any other agent appointed by the banks, breaches the requirements of the SS 30 as the Murābaha purchaser should sell the commodities itself with no agency or role from the Murābaha financiers. This shows that the structure is an organized Tawarruq in violation of AAOIFI’s SS 30.

Further, the above arrangement is in breach of the requirements under 4.1.3.4 (b) and (c) of SS 59 where it has been clarified that the client should be able to use the commodities as it desires and has full control over the sale proceeds.

5- These conditions in abridged form can be seen in the Technical Note on Tawarruq, The Journal of Islamic Business and Management, Vol. 8 Issue 1(2018) available at https://doi.org/10.26501/jibm/2018.0801-014.

6- 8/2 It is not permissible for the Institution that manages the syndication as a Mudarib, partner or an agent to guarantee the debtors of his partners, or to guarantee the contributions of these partners against exchange rate fluctuations. [see Shari’ah Standard No. (5) on Guarantees and Shari’ah Standard No. (23) on Agency and the Act of an Un-commissioned Agent (Fodooli)]

Since there is no new credit approval or disbursement of any actual funds in the second transaction, the entire exercise is reduced to the exchange of offers and acceptances with parties setting off their liabilities with each other at the end. Therefore, it cannot be considered a genuine and independent transaction from the first one; and hence does not fulfill the requirements of SS 59.

Besides, Islamic law decrees that the price in a sale contract has to be finally agreed upon at the time the sale is executed and cannot be increased under any circumstances. Therefore, Islamic banks should refrain from re-negotiating this price under the guise of increased costs, which may even be defined very liberally. However, under this structure, the banks add whatever increased costs they can attribute to the first transaction, to the subsequent short-term transactions, and this way they violate one of the cardinal pillars of Islamic banking.

As increasing portfolios are being covered under Murābaha-based syndication structures, the Shari'ah supervisory committees and the Shari'ah advisors must review the product and the processes in totality to ensure that Shari'ah requirements are fulfilled as indicated in AAOIFI's standards. Besides the validity of the earnings involved, it would enhance the integrity of the IFIs leading to increasingly broader outreach of their business.

Peer-reviewed

An insight into financial benchmark reforms for Islamic finance

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Abstract

Islamic finance ought to follow Shari'ah in all dimensions of it including regulatory, substantive and procedural matters of it. However, since the inception of the institutionalization of Islamic finance, it has been criticized for using conventional interest rates to benchmark its financial products. Irrespective of the criticisms made in this regard, from a Shari'ah perspective, this practice of Islamic finance has been defended and therefore, the practice continued until in July 2017 it was announced that there is a need to move away from LIBOR as an interest rate benchmark before the end of 2021. This announcement led to the creation of various risk-free rates and highlighted an opportunity to bring some reforms to Islamic finance by introducing financial benchmarks that could be compatible with Islamic finance principles. Therefore, the objective of this paper is to provide insight into the financial benchmark reforms required for Islamic finance by providing a review and preview of the topic using a desk review qualitative approach. The findings of this paper indicate that there could be no single benchmark that could be uniformly used for Shari'ah compliant financial products, and there is a need to introduce specific benchmarks for different types of Shari'ah contracts used in structuring Islamic finance products. It is expected that the findings of this paper would assist in understanding the theory and practice of implementing Islamic alternative benchmark to the London Inter-Bank Offered Rate (LIBOR) and would motivate regulatory authorities and standard setting bodies to consider enacting financial benchmarks that will reflect the behaviour of Islamic finance products and the underlying Shari'ah contract(s) used to structure them.

Keywords: financial benchmark; Islamic finance; reform; Shari'ah compliant financing.

1.0 Introduction

LIBOR (London Inter-Bank Offered Rate) was an interest benchmark that was being used in Islamic finance markets to determine the cost of capital and profit rates charged for financing facilities. As such, the discontinuation of LIBOR as an interest benchmark has implications for Islamic finance as well (Clifford Chance, 2020). It was in July 2017 that the UK's Financial Conduct Authority announced that there was a need to move away from LIBOR as an interest rate benchmark before the end of 2021and since then, working groups had been working to determine the best alternative overnight risk-free rates ("RFRs") for each of the five LIBOR currencies (i.e. U.S. dollar (US$); Euro (EUR); Pound sterling (GBP); Japanese yen (JPY); and Swiss franc (CHF)) (Clifford Chance, 2020).

Since the institutionalization of Islamic finance in contemporary times, LIBOR is being used for benchmarking while its use has also been criticised by several scholars who recommended Islamic finance industry to develop its own distinctive set of benchmarks to be followed (Usmani, 1998).

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Islamic finance is different from conventional finance and as such, even the pricing models used in Islamic finance ought to reflect the nature of Islamic finance principles where in every product offered there should either be an underlying asset involved or a real economic activity conducted to generate permissible revenue. As such, to transit from LIBOR as an interest benchmark is viewed as an opportunity for Islamic finance to develop its own unique pricing mechanism conforming to the Shari'ah principles (McViety et al., 2020).

The reality that is faced by the Islamic finance industry in this regard today is that transition from LIBOR to RFRs is not free from challenges (McViety et al., 2020; Clifford Chance, 2020). McViety et al., (2020) state that backward-looking overnight RFRs like the Secured Overnight Financing Rate (SOFR) for US$ transactions and the Sterling Overnight Index Average (SONIA) for GBP transactions do not lead to a viable solution for Islamic finance contracts. One example given by them to illustrate is that of Murabahah (cost-plus profit trust sale) transactions in which price must be determined at the time of entering into the contract; it would trigger Shari'ah non-compliance issues if the price is determined after entering into the contract. Since LIBOR is a look-forward term rate that is utilized to calculate interest at the commencement of a calculation period, there was no issue in using it as a benchmark for Murabahah contracts. However, for RFRs, since they are backward-looking overnight rates that are applied to a calculation period, the price could be determined only at the end of that period (McViety et al., 2020).

Regarding the Shari'ah permissibility of adopting RFRs, the statutory Shari'ah apex body for Islamic banking and Takaful of the central bank of Malaysia (Bank Negara Malaysia) provided an opinion on 23rd March 2021 in terms of which using RFRs to replace LIBOR is permissible provided that the compounding methodology is merely an arithmetic method in determining the term rate which does not affect the compliance of the transactions with Shari'ah requirements. Further, the uncertainty (gharar in the adoption of average RFR or backward-looking term rate at the point of payment must be mitigated via proper determination and disclosure of the ceiling price and formula to derive the periodic payment amount to the customer at the inception of the contract (Bank Negara Malaysia, 2021A). In this Shari'ah opinion, it was also stated that while moving to the alternative RFR, respective Shari'ah committees of the Islamic financial institutions (IFIs) must consider the suitability of obtaining the required consent mechanism to obtain customers' consent on the incorporation of the fallback provision in the contract's terms and conditions (Bank Negara Malaysia, 2021A). The adoption of RFR in Islamic finance is not only evident in Islamic banking industry, but in the Islamic capital markets also it is being practically utilized today. For instance, in April 2021, Islamic Development Bank (IsDB) announced that it had issued its first-ever SOFR-linked Sukuk in the global capital markets (IsDB, 2021).

The objective of this paper is to provide insight into the financial benchmark reforms required for Islamic finance by providing a review and preview of the topic using a desk review qualitative approach. It is imperative to note that so far, there is no comprehensive study looking at the topic considering the developments during recent years. This paper is divided into five sections. Followed by this introduction, section two discusses the justification to benchmark Islamic finance products to LIBOR by looking at the various views available on the matter. Section three presents the Islamic alternatives benchmark to LIBOR which are currently adopted by the IFIs in different parts of the world. Section four presents the recommendations followed by the last section which is the conclusion. It is expected that the findings of this paper would help in understanding the theory and practice of implementing Islamic alternatives benchmark to LIBOR and also would motivate regulatory authorities and standard setting bodies to consider enacting financial benchmarks reflecting the behaviour of Islamic finance products and the underlying Shari'ah contract(s) used to structure them.

2.0 The justification to benchmark Islamic finance products to LIBOR

Since the inception of Islamic finance, its products have been benchmarked to conventional interest rates. This practice has been validated by Shari'ah opinions issued by Shari'ah scholars and Shariah committees of the IFIs around the world, though there is no unanimous agreement among them to use it (Muneeza and Mustapha, 2022). The practice of benchmarking Islamic finance products to LIBOR is a common practice found in the world. Usmani (1998) observes that the rate of interest has been used only as an indicator or as a benchmark, and the illustration to show this point given by him is below:

'A' and 'B' are two brothers. 'A' trades in liquor which is prohibited in Shari'ah. 'B', being a practicing Muslim dislikes the business of 'A' and starts the business of soft drinks, but he wants his business to earn as much profit as 'A' earns through trading in liquor, therefore he resolves that he will charge the same rate of profit from his customers as 'A' charges over the sale of liquor. Thus, he has tied up his rate of profit with the rate used by 'A' in his prohibited business. One may question the propriety of his approach in determining the rate of his profit, but obviously, no one can say that the profit charged by him in his halal business is haram, because he has used the rate of profit of the business of liquor as a benchmark (Usmani, 1998; p.82).

Table 1 presents the justifications given by some prominent Shari'ah scholars and IFIs around the world for benchmarking of Islamic finance products to the conventional interest rate.

Table 1: Shari'ah justifications for adopting LIBOR as a benchmark in Islamic finance

Organisation / scholar giving Shari'ah opinion	Justification
Dallah al-Barakah (Majmūʻat Dallat al-Barakah, 2002)	• The usage and relying on interest rate benchmarking for Islamic product pricing does not contradict the nature of confirming the Shari'ah complaint status of the products.
Mufti Taqi Usmani (1998, P. 82)	• Usage of interest rate benchmarking does not make any contract invalid, haram or prohibited, because the deal itself does not contain interest.. However, the use of the rate of interest for determining a halal profit cannot be considered desirable.
Shari'ah Advisory Council (SAC) of Securities Commission Malaysia. (Securities Commission Malaysia, 2020)	• SAC made a resolution on the use of benchmarks as a reference to determine the floating rental rate for Sukuk Ijarah. • In the resolution, the SAC allowed using a mutually agreed benchmark or formula that determines a floating rate for rental payments of the sukuk. In addition to that, the Fatwa also stated that, there is no Shari'ah impediment in referring to any suitable benchmark in determination of such benchmark for floating rental rate. • This opinion clarifies that any acceptable benchmarks to be used in pricing financial assets or deriving the profit rates which can also be widely seen from the practical side of Islamic finance and banking industry.

Source: Extracted by the authors from Majmūʻat Dallat al-Barakah, 2002; Usmani (1998) and Securities Commission Malaysia (2020).

Irrespective of the above justifications provided by some institutions or scholars to adopt LIBOR as a benchmark in Islamic finance, the reality is that LIBOR is a mechanism which is incompatible with Islamic finance as riba is prohibited in Islam and the main reason why Islamic finance was institutionalised was to move away from riba. This is confirmed by all the Shari'ah opinions made in this regard found in Table 1. For instance, Dallah al-Barakah's Shari'ah opinion explicitly stated that:

"The reliance of Islamic financial institutions on the usage of conventional (interest rate) benchmarking such as LIBOR and other similar benchmarking in pricing their products that are based on deferred payment contracts such as Murabahah, Ijarah and Istisna' as well as using the conventional benchmarking as a as measuring instrument to value the efficiency and productivity of the Islamic bank negates the principals and objectives of Islamic banking. The conventional benchmarking index is not supposed to be utilized as a tool to calculate the composition and the cost of the bank's funds. Despite that, relying on the conventional benchmarking is a necessity in the absence of Islamically accepted benchmarking indexes" (Majmūʻat Dallat al-Barakah, 2002; 169.).

Likewise, Mufti Taqi Usmani also considered it advisable to avoid the application of interest in any form and even as a benchmark in Islamic finance to ensure that Islamic finance is different from conventional finance and to avoid resemblance of both (Usmani, 1998). Similarly, OIC Fiqh Academy in its eighth conference on Currency-related issues, in Jeddah on 18-19 Shawwal, 10-11 April 1993, unanimously passed a resolution calling for the creation of a unique set of Islamic benchmarks to determine the profit margin of Islamic products, alternative to interest-based benchmarks (Ahmed et al., 2018). Furthermore, according to Ansari (2019), even though conventional benchmarks are not haram and easier to manage for Islamic financial asset benchmarking, it is the questionnaire for fairness and transparency and is against the purpose of Islamic finance as it does not support in real economic development.

To understand why LIBOR is incompatible with Islamic finance, it is imperative to understand what LIBOR is and how it works with the main reasons why the regulatory authorities had decided to abandon it by the end of the year 2021. Though the history of LIBOR roots back to the 1960s and 1970s, it was formally adopted in 1986 to provide loan issuers the benchmark for interest rates they charge for different loans offered for different maturities. The primary objective behind the adoption of LIBOR was to ensure that financial institutions around the globe had a benchmark to set their interest rates (Marquit and Curry, 2021). As per the process involved, the ICE Benchmark Administration (IBA) eliminates the four highest and four lowest submissions from each day›s LIBOR calculation in order to avoid extreme highs or lows that could distort the LIBOR calculation. Up to 18 global banks submit daily information on the interest rates they believe they would pay if they borrowed money from another bank in the interbank lending market in London, the UK (Marquit and Curry, 2021).

In calculating LIBOR, five currencies are used and they are: UK Pound Sterling, Swiss Franc, Euro, Japanese Yen and U.S. Dollar (Marquit and Curry, 2021). Since LIBOR is calculated based on the submissions made by the banks on what they think they would charge and not on what they actually charge, it becomes easy to manipulate the rates as the banks could submit a lower rate that is different from what actually happens and such manipulation scandals have been seen in the past leading regulatory authorities to find an alternative to LIBOR (Marquit and Curry, 2021). It has been reported that LIBOR scandals led to the worsening of the financial crisis of 2008, and in 2012 even reports surfaced on LIBOR manipulation for profit among several banks including UBS, the Royal Bank of Scotland, Barclays, Deutsche Bank, and Rabobank (Marquit and Curry, 2021).

It can be observed the main reason why financial institutions around the globe are moving away from using LIBOR as a benchmark is not due to the growing scandals only; but ICE has reported that as the way the financial institutions engaged in transactions has changed, LIBOR has lost its accuracy and purpose (Marquit and Curry, 2021). Therefore, ICE does not guarantee the availability of LIBOR after 2021.

The global financial industry is transitioning from the use of LIBOR to alternative reference rates. The Financial Conduct Authority (FCA) is the regulator that oversees LIBOR which officially announced that the use of LIBOR as a benchmark should be discontinued by the end of 2021 and that the alternative reference rates (ARRs) should be adopted by June 2023. The ARRs are fundamentally different from LIBOR and already enforced by the regulators. These include Secured Overnight Index Average (SOFR) used in the United States, the reformed Sterling Overnight Index Average (SONIA) used in the UK, and Malaysia Overnight Rate (MYOR). As such, this could be an opportunity for Islamic financial institutions to collaborate with regulatory authorities in their respective jurisdictions to adopt an Islamic benchmark rate which would be an alternative to LIBOR. It is essential to note that adopting ARRs could create complexity in the comparison and implementation of pricing of financial assets.

There are four main differences between Interbank Offered Rates (IBORs) and Risk-free interest rates (RFRs) described by International Islamic Financial Market (IIFM, 2021; p.10). The first difference described is about the methodology used to calculate IBORs and RFRs where they state that IBORs are calculated based on the submissions made by the panel banks using transaction data that are available and if no such data is available based on the judgement of the experts. However, in the case of RFRs, the calculation is based on the actual transactions in the liquid markets and therefore, they opine that RFRs are considered as more robust benchmark as they are based on real transactions. The second difference described is about the terms structure, where for IBORs it is seven different forward-looking tenors from overnight to 12 months, while RFRs are backward looking overnight rates. The third difference is about the credit premium where IBOR reflects the cost of borrowing by the panel banks which includes a credit premium component while RFRs do not have a credit premium component as they are proxies to risk-free. The final difference is about consistency and timing where IBORs are based on a consistent methodology across the five currencies which is published at the same time while RFRs have different methodologies and even the publication times for each currency will differ too.

It is essential to note that, unlike LIBOR which is a “forward looking term rate” (i.e. the rate is fixed and publicly available at the start of each calculation period), ARRs or RFRs are “backward looking rates” (i.e. an RFR would be determined on the basis of historical data at the end of each calculation period. (Clifford Chance, 2020; p.2). The alternative rate used in different countries differ. For instance: the United States uses the secured overnight financing rate (SOFR) which is administered by Federal Reserve Bank of New York; in United Kingdom it is sterling overnight index average (SONIA) which is administered by Bank of England; in Euro area, it is euro short-term rate (ESTER) which is administered by European Central Bank (ECB); in Switzerland, it is Swiss average overnight rate (SARON) administered by SIX Swiss Exchange; and in Japan it is Tokyo overnight average rate (TONA) which is administered by Bank of Japan (Schrimpf & Sushko, 2019).

2.1 Secured Overnight Financing Rate (SOFR)

Secured Overnight Financing Rate (SOFR) was introduced in 2017 by Alternative Reference Rates Committee (AARC), US, as a replacement for USD LIBOR and is being used in products such as futures and floating notes. According to ARRC (2021) SOFR is “a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities in the repurchase agreement (repo) market.” SOFR also meets the international standards and is deemed as the most robust and preferred rate. However, loan markets in the United States, in particular, have been hesitant to shift away from LIBOR, and some borrowers are considering using credit-sensitive reference rates instead of the essentially risk-free SOFR. Furthermore, several operational challenges have been identified in the transition from LIBOR to SOFR, including volatility in overnight SOFR, system changes and model development requirement across the industry, as well as finalization of accounting, tax and regulatory relief to facilitate the process of transition. (PWC, 2020).

2.2 Sterling Overnight Index Average (SONIA)

Sterling Overnight Index Average (SONIA) is the preferred risk-free benchmark interest-rate in the British sterling market as an alternative reference rate (ARR) in the UK. The definition expressed in the Bank of England official website states “SONIA is based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions and other institutional investors.” (Bank of England, 2021) The financial institutions can use the rates in calculating the interest paid on swap transactions, calculating the value of sterling floating rate notes, and pricing financial contracts such as sterling bond, loan, and derivative markets. (CFI, n.d.). As an alternative reference rate to LIBOR, SONIA was introduced as a replacement to sterling risk-free rates from LIBOR. The Bank of England took responsibility for SONIA in 2016, and it was reformed in 2018 after consultation to comply with the international best practice for financial benchmarking (Bank of England, 2021).

2.3 Malaysia Overnight Rate (MYOR)

The central bank and the regulator of the financial industry of Malaysia, the BNM officially announced on 24 September 2021, Malaysia Overnight Rate (MYOR) as the new alternative reference rate (ARR) for financial benchmarking in the Malaysian jurisdiction. MYOR will run concurrently with the current Kuala Lumpur Interbank Offered Rate (KLIBOR) that is being used in Malaysia, with periodic reviews to guarantee that the financial benchmark rates remain stable and represent an active underlying market. Because both rates are available, the market has the option of using either ARR or KLIBOR as a reference rate for pricing financial instruments. The development of MYOR-based products would expand the number of hedging instruments available, allowing for more risk management strategies to be implemented in the Malaysian financial industry (BNM, 2021B). According to paragraph 4.1 of the policy document (BNM/RH/DP 028-11), ARR issued by the BNM on 19 May 2021, "the calculation of MYOR will be based on the volume-weighted average rate of unsecured overnight MYR interbank transactions comprising the following two eligible transactions: Wholesale unsecured deposits between interbank institutions (either brokered or direct/bilateral); and the Bank's overnight monetary operations, excluding Standing Facilities (SF)" (BNM, 2021B).

3.0 Various Islamic alternative benchmark rates proposed to replace LIBOR

Over the years, research has been conducted to find out the best possible Islamic alternatives benchmark to LIBOR. Though practically a comprehensive solution has not yet been implemented, the theoretical development in this regard shows that there are potential ways to find a solution to the issue. This section covers the attempts made to find an Islamic alternatives benchmark to replace LIBOR.

3.1 Inter-Islamic bank market formation based on Islamic principles

According to Ahmed et al. (2018), Mufti Taqi Usmani proposed a theory for pricing Islamic benchmarking by creating a common pool like lending in asset-backed financial instruments such as Ijarah and Musharakah. When the asset pool consists of real assets or in a factual form like equipments or business shares, the units can be purchased and sold based on the combined asset value determined on a periodic basis. The Islamic banks with surplus liquidity can formulate an interbank market by using the value of the units as an index for determining the profit of financial products that can be used as a financial tool.

3.2 Islamic Pricing Benchmark (IPB)

International Shari'ah Research Academy for Islamic finance (ISRA) (2010) suggested Islamic Pricing Benchmarking (IPB) model for the Malaysian Islamic banking industry utilizing the Capital Asset Pricing Model (CAPM) to determine the pricing benchmark in order to create a connection between the market risk and rate of return of projects or banking products (Omar et al., 2010). The study found that the IPB they developed is more stable than the Kuala Lumpur Interbank Offered Rate (KLIBOR) used in Malaysia. In order to compare the alternative benchmarking (IPB) with KLIBOR the researchers used different factors as bases including the exchange rate of Ringgit, the money supply, the price of equity stocks and industrial production (Ahmed et al., 2018).

However, the researchers found several issues in their benchmarks from the practical side as the benchmark had the real economy factors incorporated in the model, while in reality, Islamic bank's financing is more similar to the debt-based and similar to the risk and return profiles parallel to conventional banks (Ahmed et al., 2018). In the study conducted by Omar et al., (2010), the researchers even mentioned the shortcoming of the model using CAPM, as it eliminated unsystematic risk and assumed that investment portfolios were diversified in determining the correlation between the cost of equity capital and the degree of systematic risk. Moreover, IPB was developed based on real economic activities and, therefore will be costly to derive as pricing varies for different industries depending on the underlying asset (Jaffar, 2018). This was an additional factor taken into consideration by practitioners from the industry to reject this Islamic benchmark, particularly banking practitioners (Jaffar, 2018).

Later, the Arbitrage Price Theory (ATP) was developed as an extension of the CAPM model by addressing the issues in the model, by taking factors such as inflation, exchange rates, industrial production, and changes in oil prices into consideration (Omar et al., 2010; Jaffar, 2018; and Shaikh, 2021). The model also does assume that investment portfolios are diversified, and key independent variables were required to be selected in each case on the construction of the regression equation. As a major advantage of this model is that the asset return can be influenced by multiple economic factors, it is more realistic (Omar et al.; 2010).

3.3 Islamic Interbank Benchmark Rate (IIBR)

Islamic Interbank Benchmark Rate (IIBR) is the world's first Islamic finance benchmark rate established by Thomson Reuters in cooperation with Islamic Development Bank (IsDB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Bahrain Association of Banks (BAB), Hawkamah Institute for Corporate Governance and a number of major Islamic banks, that provides an average expected return on Shari'ah complaint short term interbank market funding taking the role of a reliable and objective indicator (Thomson Reuters and AAOIFI, 2011). The IIBR is defined as the rate that an individual Contributor Panel bank would perceive to be reasonable for Shari'ah compliant funding were it to do so by asking for and then accepting inter-bank offers in reasonable market size, just prior to 11:00 am Makkah local time (GMT + 3) (Siddiqui, 2012).

The IIBR is facilitating in determining the pricing of financial instruments based of Mudharabah, Murabahah, and Wakalah, and also pricing for common overnight to short term treasury investments. In addition to that, it is used for pricing of retail financing, corporate finance and investment, Sukuk, Shari'ah complaint fixed instruments, and even Shari'ah compliant Hedging Master Agreements (Thomson Reuters and AAOIFI, 2011). To derive IIBR, a poll of about 16 pre-selected banks bid the rates between 9:00 am - 10:44 am Makkah local time (GMT +3) on every business day (Sunday - Thursday). . The contributing banks include: Abu Dhabi Islamic Bank; Qatar Islamic Bank; Ahli United Bank; Sharjah Islamic Bank; Al Baraka Bank; Dubai Islamic Bank; Al Hilal Bank; Ithmaar Bank; Alinma Bank; Kuwait Finance House; Al Salam Bank; Masraf Al Rayan; Bahrain Islamic Bank; National Commercial Bank (Al Ahli); Barwa Bank; Noor Bank; and National Bank of Kuwait. The rates are ranked from highest to lowest and the top and bottom quartiles (25%) of the rates are excluded to ensure that outliers do not influence the distribution. The arithmetic mean (average) of the remaining mid-quartiles' values is then calculated to find out the IIBR. All this process is conducted by Thomson Reuters as was in the case of LIBOR, KIBOR, etc. IIBR governed by the Islamic Benchmark Committee was certified in 2011 by the Shari'ah committee comprising AAOIFI scholars: Justice Muhammad Taqi Usmani (Chairman); Professor Dr. Mohammad Abdul Rahim Sultan al Olama; Shaykh Muddassir Siddiqui; Professor Dr. Mohammed Daud Bakr; Shaykh Yusuf Talal DeLorenzo; and Professor Dr. Akram Laldin (Thomson Reuters and AAOIFI, 2011).

According to Shaikh (2021), IIBR is primarily a quoted rate with few real trades, and LIBOR influences the contributing rates. Moreover, the IIBR has a long-term relationship with conventional rates and fails to be an independent benchmark (Nechi and Smaoui, 2019). However, pricing and valuing benchmarks exclusively for Islamic instruments, require more deliberation from legal, economics and Shari'ah perspectives due to the issues as mentioned earlier (Shaikh, 2021). A similar view is observed by Dr. Mohammad Omar Farooq who attempted to deliberate on the question of whether IIBR fills the gap of the need for Islamic finance industry to have its own Islamic benchmarking mechanism. In this regard, he said:

Let's begin with a fundamental query: Is the input base of IIBR different from its conventional counterpart, such as LIBOR? The answer to this question depends on whether the current Islamic banks themselves are using an independent rate that is not linked to the interest-based conventional benchmarks. Unfortunately, the current practice is directly linked to conventional, interest-based benchmarks. Of course, this benchmarking to interest-based rates has been halālized by the fatwá authorities. In such a context, coming up with a benchmark rate that is based on its constituent banks' conventionally-benchmarked rates is at best superfluous (JIBM Discussion Forum, 2014; p.155).

IIBR is different from LIBOR as using IIBR, unlike LIBOR which measures interest rates, IIBR measures the expected profit rates providing guidance to determine the cost of raising Shari'ah compliant funding by deriving it using returns generated from Islamic assets (Thomson Reuters and AAOIFI, 2011). However, the undeniable truth is that IIBR has not been accepted and adopted widely in the Islamic finance industry which could be due to its weakness in adequately gaining the confidence of the industry as an independent rate de-linked from conventional benchmark rate (JIBM Discussion Forum, 2014).

3.4 Islamic Pricing Benchmark Model (IPBM)

A study conducted by Ahmed et.al., (2018) suggests an Islamic Pricing Benchmark Model (IPBM) as an alternative Islamic benchmark to LIBOR helps to identify the investment for target rates of return and break-even point on expected cashflows of financial projects. The objectives of this model are to encourage the utilization of tools used in Islamic finance by changing the reliance on the negotiation made between the parties by the percentage distribution of profits between "Islamic securities holders" on the basis of cash flows, and to adopt an alternative benchmark other than LIBOR to Islamic securities market.

The rate of return of any project in the proposed model will take into consideration the future cash flow pertaining to the amount of invested capital. In determining the expected cash flow in the future, the general economic condition will be considered. This means that the investor will have to be provided with a detailed feasibility report of the project to understand the risks and returns by relying on it. Therefore, the IFIs which are the financier will have to obtain such a report from the customers and will have to evaluate it prior to taking the decision to invest in the project or not. This proposed model focuses on the distinction between the inflow and outflow of case in order to arrive to an informed investment decision.

In using IPBM benchmark, Ahmed et al., have proposed four Shari'ah parameters that should be used. They are: the regulators shall ensure that there are certain benchmarks to determine possibility of deceiving behaviour in the projections made; there shall be full and frank disclosure of material details of pricing benchmarks used to all contracting parties; impairment of risk ought to be included in computing of pricing at the commencement stage and not at the default stage; and finally, the factors used in determining the pricing benchmark must not have any Shari'ah non-compliant indicators such as interest or other non-halal activities.

3.5 Tobin's Q Theory

This model was developed by Abbas Mirakhor (1996) as an Islamic benchmark alternative to conventional interest-based benchmarking. In this model, the cost of capital can be generated without a fixed and predetermined interest rate based on Tobin's Q. The model can be applied in both the private and public sectors in obtaining a benchmark that reflects the investment whose price is derived. In this model, the rate of return will be based on financial ratio of Return on Capital Employed (ROCE), where capital will be valued at replacement cost. The cost of capital will be the ratio of the profit or return to the company›s financial valuation (Mirakhor, 1996). However, only equity finance projects are applicable in determining the cost of capital as a benchmark against the expected return and where debt instruments are not applicable (Mirakhor, 1996; Ahmed et al., 2018; Omar et al., 2010). On the other hand, there is no practical evidence of implementation of this model as Islamic benchmarking alternative to conventional-based interest rate benchmarking.

3.6 Islamic Rate of Return (IRR) for financing

IRR is proposed by Hasan et al., (2020) where they believe that the pricing benchmark for financing used in Islamic finance shall be linked with real economic activities. IRR is derived from the notion of "market price" in Islamic jurisprudence where the autonomy to decide the price for commodities are given to the market. The theory of general equilibrium theory is used to develop IRR where it is viewed that when the supply and demand of funds meet, it is considered to be an equilibrium point where the prices would remain stable. This would be in the absence of a shortage or surplus market. This proposed, IRR model is based on five presumptions: the financing unit traded in the equilibrium market is homogeneous; the equilibrium market is complete and efficient in which, all investors (depositors and financiers) have sufficient information about the market; equilibrium market contains many investors, and they are competing honestly; investor's investment decisions in an equilibrium market are completely independent of the financiers' decisions; and the equilibrium market is completely independent of other types of markets (Hasan et al., 2020). Hasan et al., (2020) presume that the Economic Growth Rate (EGR) Index indicates the equilibrium state of interest rates, which indicates the right opportunity cost for the financial transactions conducted and therefore, it can be applied in computing the Islamic Rate of Return-IRR index instead of Using Risk-Free Rate (RFR) which is debt based. In determining IRR, the general equilibrium theory with the Asset Price model is used considering the Market Risk Premium and daily fluctuations and changes in the levels of supply and demand funds.

3.7 Islamic Finance Returns (IFR) benchmark

IFR benchmark is proposed by IsDB and it has two components: expected inflation, which is required to protect the real value of capital, and expected growth of real GDP, to compensate for the average opportunity cost (Islamic Development Bank & Islamic Research and Training Institute, 2020). These two components of IFR benchmark are viewed as being more aligned with Islamic finance principles as they cover the factors in a real economy rather than relying solely on interest rates. There are five recommendations put forward by IsDB in developing and adopting the IFR benchmark and they are: enacting appropriate mechanisms for collecting expectations of inflation and of growth of real GDP in IsDB member countries; publishing the resulting data periodically in collaboration with authorities; IsDB collaborating with other multilateral institutions for establishing a reliable mechanism for collecting data on expectations, and IsDB considering benchmarking its rate of return on its Sukuk and other assets to collected expectations. They believe that the more aware the IFIs are of the real costs of financing, more progressively they will be revising their pricing to be in line with the real economy while preserving the real value of their capital (Islamic Development Bank & Islamic Research and Training Institute, 2020; pp.24-25).

4.0 Issues, potential and recommendations

The development of an Islamic market benchmark would definitely reflect the true essence of Islamic economics and Islamic teachings on fairness and justice (ICD, 2015). Nevertheless, there are several issues and challenges in developing a robust Islamic benchmark in the Islamic financial industry. In pure Islamic benchmarking, it is anticipated that the return shall be derived from real economic activities and enforcing any new benchmark in this base could lead to unexpected changes in investment returns and profit distribution. This could potentially lead to displaced commercial risk where the customers may be fearful of keeping their money in Islamic banks. It would also be challenging to form Islamic interbank liquid market using a new Islamic benchmark, since it would require mass awareness amongst the wide range of stakeholders (ICD, 2015). Moreover, usually, the real economic activities are highly volatile and deriving a new benchmark would also limit the market volume, which contributes to increase volatility and uncertainty of values and benchmarkings. It is also important to note that most of the real economic data are based on historical information, and it is questionable whether the benchmark derived using these data reflects and accurately predicts the expected profit rate.

Moreover, if the benchmarks are derived based on the financing types, it will be challenging for the bank to derive a yield curve, and thus will be challenging to asset and liability management. Furthermore, it might also lead to arbitrage opportunities by swapping assets when a different benchmark is used for different types of financing. In addition to that, it is also important to determine whether the banking customers are capable enough to accept the profit rates or pricing derived from real economic benchmarks. Since LIBOR and other conventional benchmarks are widely practiced, customers are aware of the fluctuations and might be hesitant to obtain banking facilities priced and valued using such a benchmark.

There is no doubt that need for adopting the alternative reference rates (ARRs) have provided the opportunity for the Islamic financial institutions in collaboration with the regulatory authorities and standard setting bodies for Islamic finance to implement an Islamic ARR. In formulating the Islamic ARR, it is imperative to consider a Shari'ah-based mechanism to compute it by considering the ideal way in which Islamic finance needs to be conducted. This simply means that Islamic ARR should not be formulated to continue the existing way of how the financial products are structured in the industry; rather, it should be formulated to pave for Islamic finance industry to show its distinctiveness to its conventional counterpart. Therefore, it is recommended to create the Islamic ARR in a way that different benchmarks could be used for different types of Shari'ah contracts used to structure Islamic finance products. For instance, if the Islamic finance products are structured based on debt-based contracts, then the benchmarking should be made based on the price of the underlying commodity used while if the financial product is structured using a lease mode like Ijarah, then the benchmarking should be made to the rent of the asset leased which is found in the market rather than merely relying on cost of funding (Muneeza and Mustapha, 2022). Likewise, if the Islamic finance products are structured using equity contracts, then the type of business activity with its risks and returns must be considered to set the profit-sharing ratio while promoting a floating return (Muneeza and Mustapha, 2022).

In this regard, Gazali et al., (2017) formulated a base profit rate (BPR) model which they believe is a more Shari'ah compliant model as an alternative benchmark for Islamic banking. They view that though the objective of both Islamic and conventional banking is to make profit, the determination of profit rate in Islamic banks in the context of Malaysia are derived from reference rate which is known as the base rate (BR). BR is determined using components like cost of funds and the statutory reserve requirement (SRR) which they believe is non-compliance with the Shari'ah as it is directly proportional to the overnight policy rate (OPR).

Further, to resolve the challenges found in "backward-looking" RFRs, using Murabahah transactions as an example, Clifford Chance (2020) has proposed three potential solutions. The first solution is entering into multiple Murabahah transactions where spread rate Murabahah and bench mark rate Murabahah can be combined. The second solution proposed is the reconciliation of payments method where a typical Murabaha contract can be entered where ahead of each calculation period the profit rate is set in advance on the basis of the available "backward-looking" RFR which will be recalculated using "backward-looking" RFR for that calculation period. The final solution proposed is high profit rate margin with purchase undertaking or rebate where a single Murabaha contract will be entered into at the outset of the transaction with a final deferred payment date corresponding to the maturity date of the transaction and within the duration of the facility. On each deferred payment date the obligor will have the discretion to pay a lower amount calculated on the basis of the aggregate of the actual benchmark rate and the spread rate.

Armstrong et al., (2021) like Clifford Chance (2020) have acknowledged that there are some complexities that Islamic finance is faced when the usage of LIBOR is discontinued for benchmarking especially in the context of Gulf Cooperation Council (GCC) region and adoption of SOFR. The first reason they stated is that the approach used in calculating the compounded SOFR (which is calculated by compounding interest over the current interest period) leads to breach of principles of elimination of Gharar Fahishah (excessive uncertainty) in Islamic finance transactions. The second reason they stated is about the Shari'ah governance processes implemented in approval of Islamic finance products that require approval from the respective Shari'ah organ of the Islamic financial institution which means that the ARRs used might not be compatible for all kinds of Islamic finance products used. As such, they believe that for Islamic finance products based on Murabahah or Ijarah (leasing), a specific approach might be required. As a solution to this issue, they have proposed the use of dual Murabahah approach, the ceiling Murabahah approach for Murabahah. For Ijarah, the sub-period Ijarah approach and the daily rental Ijarah approach is proposed. The final issue they have highlighted in this regard is getting express guidance from AAOIFI as AAOIFI standards are used in GCC. It is to ensure that ARRs adopted are AAOIFI Shariah Standards-compliant as well.

International Islamic Financial Market (IIFM, 2021) proposed the ways in which replacement benchmarks could be used across core Shari'ah contracts. For instance, it is stated that for Ijarah (financial lease), the lease rental could be determined using Replacement Benchmark rate (Backward-looking) available on the Quotation Date and usually collected in arrears while for service agency (asset-based) contracts, income would be determined using applicable Replacement Benchmark rate (Backward-looking) available on Quotation Date and usually collected in arrears. For Murabahah, profit is determined using applicable Replacement Benchmark rate (Backward-looking) available on Quotation Date and collected in arrears and for Musharakah / Mudarabah / investment Wakalah, profit distribution is determined using applicable Replacement Benchmark rate (Backward-looking) available on Quotation Date and usually collected in arrears.

When the above proposed solutions are reviewed in the light of Maqasid al Shari'ah (objectives of Islamic law) or using a Shari'ah based approach, the undeniable truth is that what we are intending to do is mimicking the conventional financial products; rather than distinguishing the Islamic finance products from it by designing those products in a true Shari'ah based manner. When LIBOR was used for benchmarking, it was Islamic finance contracts and products that were customized to suit the "norm" of the financial industry disregarding its true nature which should reflect the value of the underlying assets or real economic activity used to generate the permissible financial outcome. As El-Gamal (2003; p.1) has put it: "…the bulk of Islamic financial practices formally base rates of return or costs of capital on a benchmark interest rate such as LIBOR, and would easily be classified by any MBA student as interest-based debt-finance."

Instead of justifying this practice, moving away from LIBOR gave hope to the Islamic finance industry that it could develop its on ARRs and would use the opportunity to implement Islamic finance using a Shari'ah-based approach. Unfortunately, even after the demise of LIBOR and the introduction of ARRs, what Islamic finance industry is doing is continuing to mimic conventional finance and justifying the conventional benchmarking to be used for Islamic finance by legalising them. For instance, why should the daily rental Ijarah approach be introduced when in fact there is opportunity to value the asset rented and determine the rental rate for asset based on the rental market variations? Making money out of money is prohibited in Islamic finance and if so, even after having an underlying asset in the transaction, why to still follow the pricing mechanism used for those financial institutions that are engaged in making money out of money transactions?

Further, when an underlying asset is involved or a real economic activity is done to do the Islamic finance transactions, even the risks associated with the underlying asset, or the real economic activity shall be borne by the parties according to the Shari'ah contract used to structure the financial product. As such, it is recommended for Islamic finance standard setting bodies such as AAOIFI to look deeply into this matter and find Shari'ah-based ARRs to guide the Islamic finance industry. Table 2 shows the type of ARRs that could be suitable for different Shari'ah contracts used to structure Islamic finance products. The practical implementation of these proposed mechanisms needs to be studied further to understand the issues in implementing them before a proper conclusion in this regard can be crystallized. It is confirmed that interest-based benchmarks do not represent real economic activities (Ghauri, 2015; Hasan et al., 2020).

Shaikh (2021) has proposed four options as alternative benchmark rates in Islamic finance and they are:

1. For interbank / financial market benchmark, RFRs can be accommodated by determining the profit rate at the time of Murabahah transactions using a higher rate and providing a rebate or reconciliation of profit rate in next calculating period.

2. For Islamic interbank / financial market benchmark, a bottom-up approach where rates could be derived from the sovereign Ijarah bills can be used in case the commercial banks want to deposit funds with the central bank, they will buy Treasury Sukuk Ijarah Bills at a lower price on spot and sell at a higher price in future and if they want to access funds from the central bank, they will sell Treasury Sukuk Bills at a lower price on spot and buy at a higher price in future where the difference in price will be the financial cost to the party that is obtaining funds and return to the counterparty that is providing funds.

3. Real economy-based macro benchmark where expected nominal GDP Growth, expected GDP Growth Rate + Premium, and seasonally adjusted output price index can be used; and finally,

4. Real economy-based micro benchmark using rental rates from rental indices or asset price and commodity price indices, and implied profit rate on commercial contracts can be used.

Table 2: Proposed Shari'ah-based ARRs for different Shari'ah contracts used to structure Islamic finance products

Proposed Shari'ah-based ARR	Shari'ah contract(s)
Inter-Islamic Bank Market Formation based on Islamic principles	Ijarah and Musharakah Mutanaqisa (movable property)
Islamic Pricing Benchmark (IPB); Islamic Pricing Benchmark Model (IPBM); Tobin's Q Theory	Ijarah (immovable Property) and equity contracts (Musharakah and Mudharabah)
Tobin's Q Theory	Equity contracts (Musharakah and Mudharabah)
Islamic Interbank Benchmark Rate (IIBR)	Debt-based contracts
Islamic Finance Returns (IFR) Benchmark; Islamic Rate of Return (IRR)	For all types of Islamic finance contracts

Source: Author's own

Lastly, in this regard the most important question that needs an answer is: from a Shari'ah perspective, what are the most desirable features that ought to be found in ARRs formulated for Islamic finance? Islamic Development Bank and Islamic Research and Training Institute (2020) have provided a comprehensive answer for this question. They suggest that an Islamic benchmark formulated should be: independent from interest rates; based on, or backed by, sound economic rationale; simple and easy to produce; and widely acceptable and must potentially reduce the severity of financial crises (Islamic Development Bank and Islamic Research and Training Institute, 2020; p.6). As such, the ultimate ARRs used in Islamic finance should have the above features to ensure that Islamic finance reflects its true nature in all its dealings and transactions.

5.0 Conclusion

Islamic finance is different from its conventional counterpart as the former promotes engaging in real economic activities by entering into partnerships or exchange contracts for profits and rentals, while the latter makes money out of money by charging interest. As such, in structuring Islamic finance products, it is not only the cost of funding that ought to be considered by benchmarking its pricing with LIBOR, but the various underlying contracts used in it ought to determine the way it shall be priced, and which benchmark ought to be used. At a time when the whole world is moving from LIBOR to ARRs, it is indeed the right time for the stakeholders of Islamic finance to adopt an Islamic ARR for Islamic financial institutions to follow. The existing ARRs formulated are incompatible with Shari'ah as all the ARRs are linked to the money market rather than the real economy.

It is anticipated that this paper will assist the stakeholders in understanding the options available in this regard. An empirical study on the existing Islamic benchmarking would definitely be useful for the practitioners and would amply contribute to the existing literature on Islamic benchmarking. At the same time, there is a need for Islamic finance standard setting bodies such as AAOIFI to provide explicit guidance in this regard.

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Pakistan's Federal Shariat Court's judgment on Ribā: Lesson for transforming the economy and reforming the Islamic finance industry

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Abstract

Despite Islamic banking being promoted in Pakistan as in other parts of the world, there emerged a debate in the country whether the modern commercial interest tantamounts to ribā as prohibited in Shari'ah. The Federal Shariat Court of Pakistan (FSC) in its judgement on ribā, pronounced on 28 April 2022 declared that ribā in all its forms is prohibited and directed that the system based on interest must be replaced latest by end-December 2027. But the State Bank of Pakistan and some banks preferred appeals before the Shariat Appellate bench of the Supreme Court of Pakistan.

The objective of this paper is to analyses main contents of the Judgment (FSC, 2022) and discuss the extent to which it addressed the issues raised by the Supreme Court in its Order while setting aside the earlier judgments in 2002. It also discusses the steps to be taken by the government, banks and other stakeholders in transforming the economy and the financial system into Islamic. Keeping in view the objectives of transforming the conventional system to Islamic principles as indicated by the Court (2022), it also indicates the weaknesses of the Islamic finance industry as evolved so far and the need for addressing them while the economy and the financial system are transformed to be Islamic. The measures suggested could be helpful in transforming the entire economy as required by the Constitution of Islamic Republic of Pakistan.

Keywords: Ribā, Interest, Islamic banking, Pakistan, form versus substance, equitable wealth distribution, Islamization of economy, OIC member states.

1. Introduction

Pakistan was among the few countries that initiated evolving Islamic financial system at a nationwide level in the late 1970s and early 1980s. But due to failure in implementing Islamic finance principles in substance, the nation-wide 'Non-Interest Based' (NIB) system of 1980s was declared un-Islamic by the country's Federal Shariat Court (FSC) in 1991. The government took an easy way out of challenging the very connotation of ribā. Despite the rejection of appeals against the FSC judgment (1991) by Shariat Appellate Bench (SAB) in 1999, the government tactfully maneuvered not to implement the Constitution's 'Principle of Policy' of 'eliminating ribā' from the economy for decades to come. As a result, the task became increasingly difficult mainly due to the piling up of the public debt which will briefly be discussed in this paper.

Practically for Islamic banking and finance industry around the globe, there are two approaches: i) developing an entirely different structure and

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framework than the existing financial system; and ii) working within the existing system to achieve the dual objective of Sharī'ah compliance and profitability compared to the existing businesses (Hanif and Ayub, 2021). As the second option of parallel functioning of the conventional and Islamic systems suited more for business and profitability, it was adopted in many Muslim-majority countries and across the world.

Having seen the working of the dual system in terms of increasing business activity without much change in substance, this approach was also adopted in Pakistan where the Constitution (1973) and the Shariat court (1991 and 1999) required transformation of the whole system. As from 2002, the government switched to the dual system leaving other areas of finance, almost unattended.

Earlier, all base work for the Council of Islamic Ideology (CII) and the Shariat courts, whenever needed, was conducted by the State Bank of Pakistan (SBP) with the objective as per the constitution and the direction given by the Father of the Nation, Muhammad Ali Jinnah (Janjua M. Ashraf, 2003). But now the SBP's policy seems to shift towards providing a 'level-playing field' to both interest-based banks and Islamic banks. The banks› focus moved to tapping the market to attract funds from the faith-sensitive population without giving much attention to realizing the objectives for which Islamic finance was to be evolved amidst the already developed conventional finance.

The FSC in its judgment on ribā (2022) addressed significant and crucial issues relevant to the modern financial system based on interest and the current financial and commercial laws governing that system in Pakistan. The court declared that ribā in all its forms is prohibited in Islam and the commercial or banking interest does fall under the domain and scope of ribā. It directed, therefore, that the system based on interest must be transformed to interest-free basis latest by end-December 2027.

1.1 Plan of the paper

The paper is divided into 5 Sections. Section 2 gives the historical perspective and the uniqueness of Pakistan's case. Section 3 analyses the main parts of the FSC verdict (2022) and discusses the extent to which it addressed the issues raised by the Supreme Court's SAB in 2002 in its order setting aside the earlier judgments. Section 4 discusses the post-judgment developments, analyses the possible issues in the transformation of the system, and suggests steps to be taken in this regard. Section 5 briefly indicates the weaknesses of the Islamic finance industry, and the importance of addressing them while the economy and the financial system are being transformed to be fully Islamic. Section 6 concludes the paper.

1.2 Methodology

This technical paper uses qualitative methodology to analyze the aspects involved and find out possible implications and the lessons learnt. It discusses the existing phenomenon of Islamic banking working parallel to the conventional system. It draws specific lessons and recommends a future course of action in moving towards an economy-based financial system. Taking Pakistan as a case study in this context, it suggests strategies and steps for the future course of action. Based on the growth and development so far, it identifies the opportunities, potential challenges, and a possible way-out for transforming the present system to an ethics and value-based system for shared and sustainable growth and welfare-oriented economies.

2. Historical perspective and the uniqueness of Pakistan's case

All laws and the system in the Islamic Republic of Pakistan have to conform to the Islamic principles as laid down in Quran and Sunnah. Article 38 of the country's constitution (1973) states:

"The State shall— (a) secure the well-being of the people, irrespective of sex, caste, creed or race, by raising their standard of living, by preventing the concentration of wealth and means of production and distribution in the hands of a few to the detriment of general interest and by ensuring equitable adjustment of rights between employers and employees, and landlords and tenants; …..
(e) reduce disparity in the income and earnings of individuals, including persons in the various classes of the service of Pakistan; (f) eliminate ribā as early as possible. [emphasis added]"

Article 227 mandates: "All existing laws shall be brought in conformity with the Injunctions of Islam ..., and no law shall be enacted which is repugnant to such Injunctions".

Regarding the explanation of 'ribā', the Council of Islamic Ideology (CII) in 'The Report on the Elimination of Interest from the Economy', (1980), declared that commercial interest is ribā, and dealt with in detail the measures to be taken for elimination of interest. The report reflected the collective wisdom of eminent scholars of all schools of thought as CII's members, renowned economists and bankers of the country as members of the Panel of Economists and Bankers (constituted by the CII), and six Working Groups set up in the SBP in 1978 for preparing the alternative system (Janjua M. Ashraf, 2003).

2.1 Practical steps towards Islamic banking and finance in Pakistan

While Islamic finance is being evolving all over the world, the uniqueness in the case of Pakistan is that its constitution mandates the State of Pakistan and its institutions such as the parliament, the ministries of finance and economic affairs, SBP, Securities and Exchange Commission Pakistan (SECP), etc. to 'eliminate' ribā from the economy as early as possible (Article 38f).

Accordingly, in the late 1970s and early 1980, efforts were made to Islamize the economy. But the NIB banking introduced during 1980-1985 culminated in a system based generally on bai'al'inah and the sale and purchase of debt instruments. It was declared un-Islamic by the FSC in its landmark judgments in 1991. The court ordered that the entire system must be transformed conforming to Islamic principles by end-June 1992. But the state officials opted to hide behind some constitutional provisions, or presumed view of some jurists / scholars to plead that 'interest' was not ribā as prohibited by Quran. Appeals preferred against the FSC judgment (1991) before the SAB remained pending until 1999.

The SAB, in its decision dated 23 December 1999 confirmed that modern commercial interest involved ribā which must be eliminated from the economy by the end of June 2001. However, the specially constituted SAB, in its short Review Order dated 24 June 2002 handed the case back to the FSC for re-hearing. The issue raised in the Review Order, inter alia, included:

a) Ribā was finally prohibited by verse 3: 130 – doubled and redoubled, and the use of reason required for its explanation in the modern age;

b) the FSC (1991) did not differentiate ribā from bai, usury, or interest;

c) views of prominent Arab scholars such as Abduhu, Rashid Rida, Sanhori, Tantavi, and Khallaf have not been considered;

d) if Ribā al fadl was not clearly defined by the FSC (1991), then why has it been discussed and decided by the SAB (1999)?

e) the issue of inflation and indexation has not been clarified, in this regard, the term rasalmāl (as the term used in Quran – traditionally, the amount of debt incurred and payable) must be redefined;

f) whether the Islamic banking model is practical, and whether the current Islamic banking is a kind of heelah (حيلة) (ruses or juristic tricks);

g) Quran discusses Qarḍ with the meaning of 'sadaqāt' while banking deposits are simply investments;

h) the issue of international commitments for payment of interest and how to deal with the future foreign borrowing of the government by following the Islamic injunctions; and

i) the government lawyers also raised the issue of the application of ribā rules on non-Muslims.

At the FSC, re-hearing could not be initiated for over 10 years until 2013. It continued till April 2022 when the judgment was delivered by the FSC (2022)

3. Analysing the Judgment (FSC, 2022) and discussing its implications

The Court discussed in detail the term 'ribā' and concluded that all forms of modern commercial interest, irrespective the rate, is ribā as prohibited in Islam. While referring to 12 Quranic verses which deal with the term ribā, the judgment referred to around 100 commentaries of Qur'an, from different schools of thought, and also from the resolutions of the Jeddah-based Islamic Fiqh Academy of the OIC. For detailed exposition a quote from the judgment is as follows:

"Shari'ah strictly prohibits all types of ribā; therefore any kind of socio-economic, legal or religious change in the borrower or the lender of a loan transaction involving ribā does not change the nature of prohibition. Ribā is equally forbidden for the poor and the rich and for Muslims and the Non-Muslims in an Islamic State. Similarly, nature of its prohibition does not change with the change in the purpose of taking loan; which mean that the loan taken on ribā for commercial, productive of industrial purpose is as prohibited as the charging of ribā upon a loan which is taken to fulfill personal need. Likewise, change in the ratio of percentage at which ribā is charged on a loan in a transaction does not change legal effect of prohibition of ribā in a transaction." (P. 143, 144; para. 47)

Regarding alleged viewpoints of some Arab scholars or other authors, the FSC observed that the same were based on apprehensions and not any arguments, which could be adequately dispelled or removed by proper analysis (FSC, 2022, para. 13).

The FSC removed all apprehensions relating to any laws or provisions of the law that were challenged. In doing so it involved all stakeholders including economists, researchers, experts in constitutional law, Shari'ah scholars associated with banks, politico-religious parties, and Islamic banking practitioners. It also discussed the objectives of Islamic economics and finance. the court however, did not discuss, or partially discussed some areas like issues relating to ribā al fadl, impact of inflation on the capital for loans or debts (rasalmāl), and whether the current Islamic banking practices involved any heelah or not (this view was rejected without any detail or argument in favour of the validity of Islamic banking practices). Some of these issues in the judgment are discussed and analyzed below:

3.1 Explaining Ribā al fadl

The FSC also discussed ribā al fadl, while discussing the following three barter transactions:

a) transaction of money for money of the same kind where the quantity on both sides is not equal, either in a spot transaction or in a transaction based on deferred payment. However, the FSC skipped the delayed exchange of the two monetary units (as it indicated in the case of weighable or measurable commodities), which is the most pertinent part of the well-known hadith about the exchange of six ribawi items (fungible goods that could be used for payments and might involve ribā) including gold, silver, wheat, barley, dates, and salt;

b) exchange transaction between two weighable or measurable commodities of the same kind, where the quantity on both sides is not equal, or where the delivery from any side is deferred; and

c) exchange transaction between two different weighable or measurable commodities where delivery from one side is deferred.

However, the FSC (2022) omitted an important category of delayed exchange of two different currencies. Thus, a fourth category should have been added to the above list in the following words:

d) "exchange of money for money of different denominations or different monetary units (currencies) where delivery from one side is deferred".

The last one is an important and common form of ribā about which the judgment is silent. According to Islamic law, if gold or dollars are to be exchanged for silver or Pakistan rupees, for example, the exchange must be hand to hand. The rules of ribā-al-fadl related to money and monetary units are relevant and important even today as the sale and purchase of currencies and dealings in forex related derivatives are the speculative business activities of banks and financial institutions that have the tendency of creating crises in the global economy.

The rationale behind the invalidity of non-simultaneous exchanges between two currencies is to provide both parties equal opportunity in the business to benefit from the exchange values and to save the parties from possible loss or exploitation of one party by the other due to change in their mutual exchange value by appreciation or depreciation.

Islam provides different laws for mutual exchange of the general commodities useable by human beings (plural of `ayn), and the athmān (such fungible goods) that can be used as money. The third category of dayn (debts / receivables is covered under the exchange rules of athmān. According to this law two different currencies like dollar for rupee, as in the case of gold for silver, have to be exchanged on hand-to-hand basis. The omission by the FSC (2022) as indicated above will have very serious implications as it provides a gateway for manipulating the established Islamic exchange law. We experienced the first irregularity of this kind when the SBP, only a couple of months after the judgment, adopted AAOIFI's Shari›ah standard (SS) 10 on Salam, vide the Islamic Banking Department (IBD) Circular No. 01 of 2022 dated 04 July 2022. The circular, however, excluded the words 'or currencies' from the goods eligible for Salam transactions. A Footnote has been added to Clause 3/2/4 of SS 10 that reads as follows:

"It is not permissible for al-muslam fihi to be gold or silver, if the capital of the Salam contract was paid in the form of gold or silver."

The actual Clause 3/2/ 4 of SS 10 is, "It is not permissible for al-muslam fihi (subject matter or commodity of Salam) to be an amount of currency, gold or silver if the capital of the Salam contract (thaman or price) was paid in the form of currency, gold or silver. It means that as per SBP IBD circular, currencies like dollars, rupee, riyals, etc. could be the subject matter of Salam [one currency to be delivered in future, against another currency paid in advance].

International Fiqh Academy, Jeddah and AAOIFI have categorically declared that modern paper currency is like gold and silver or like the old dinar and dirham and that all rules of riba al-fadl and bai al-sarf apply to it.[2] Similarly, AAOIFI (SS 10) does not allow credit sale of monetary units and Salam in currency, as indicated above.[3] Similarly, AAOIFI's SS 8 on Murābahah prohibits deferred Murābahah in currency. It says, "It is not permitted to carry out a Murābahah on deferred payment terms where the asset involved is gold, silver or currencies".[4] The same position has been emphasized in SS 1 "Trading in currencies".

The above omission by the FSC (2022) could become a basis for allowing currency forward contracts and futures, prevalent in global capital markets, promote speculative activities and ultimately lead to 'bubble & burst' and instability in the market, as in the current system.

3.2 The issue of inflation and the Islamic law

The FSC (2022) also left the issue of inflation and its impact on capital of debts unsettled although the SAB (2002) required it. The FSC (2022) noted:

"Paragraph 15 of the Remand Order is related to the fiscal question relating to inflation and indexation, which were discussed before the SAB Presently there does not exist any law which contains this issue therefore discussing this issue is irrelevant and outside the scope of this court. This is outside the scope of the jurisdiction of this Court at the moment" (paras. 110 and 111).

This, however, is an issue that must have been decided by the FSC. [SBP raised this issue again in their appeal dated 25 June 2022]. The issue of inflation and indexation may not be relevant in banking transactions, but it is certainly relevant in other financial and commercial transactions, and many people try to create ambiguity about the prohibition of interest due to inflation. A few others try to redefine the term 'Ra'salmāl' as the issue raised by the government's counsels.

This issue arises because the difference between the two aspects is not taking into account: i) a commercial activity - necessary for a profit, and ii) a benevolent activity to favour anyone in need; and then various categories of commercial activities – loan / debt, sale, lease or partnership based on Mudārabah / Mushārakah principles. While a benevolent action is not taken for any worldly benefit, different commercial activities and transactions would involve a return according to different principles applicable to sales, loans / debts and partnership capital. As per the Islamic law, all like-for-like exchanges be executed on an equal basis in terms of the relevant units of exchange. A lender or creditor has the right to receive the amount of credit given. If this does not suit someone, he / she is free to avoid a loan contract and to pursue an alternative such as sale, lease or any partnership-based arrangement.

One genuine business deal, even in the pre-Islamic period was that in case one wishes a return on his / her money, he might give it to someone who can do business with it, and share the profit, if any; and take the business loss, if it happens. Prophet (PBUH) did this with funds provided by Khadijah (RA). Providing trade finance by way of credit business was also there. But any return on loans given and debts incurred was prohibited. It implies that, along with ribā-based methods, such valid methods of getting return were there.

Profit or return on financial capital can be earned if capital is linked to any liability, risk or responsibility. If one wishes to avoid erosion of money's value, one should do business with it; if not oneself, then by other who can become an entrepreneur, and give him the wage if he served as an employee for managing the business, or give a share in profit, in case of Mudarabah. Keeping in view the same principle, orphans' money is desired to be invested in business so that Zakat paid annually should not erode capital.

As such, financial contribution may take different

2- Intl. Islamic Fiqh Academy, Resolution 16th October 1986

3- Art. 3/2/4 Shariah Standard no. 10

4- Art. 2/2/6 Shariah Standard no. 8 Murābahah forms – loan, investment agency or partnership; if a loan or a debt, it is to be paid back exactly in the same kind and quantity, irrespective of intrinsic value of the amount given or any change in the value of the given currency or price of the commodity lent or borrowed, at the time of return of loan. The value of dirhams depreciated in terms of dinars even during the early Caliphate period (Maudoodi, 1982). But we do not find any reference in the whole literature on Islamic jurisprudence to the concept of indexing with any other commodity or money on account of fluctuation in the value of money.

Drawing benefit from the loan invokes prohibition. The value of money decreases even if one keeps it with him. Linking repayment of a loan with inflation would mean getting benefits from loaning operations. What will happen in case of fall in price levels as happened some years ago in case of gold. Al-Jaziri (Kitab al Fiqh) has given an interesting example, 'A' purchased on credit four pounds of meat at the rate of 5 Qirsh (a former coin and fractional monetary unit of several Middle Eastern and North African countries) per pound (total amount payable 4x5=20 Qirsh). If at the time of repayment, meat's price falls to Qirsh 2 per pound, even then 'A' will have to pay 20 and not 8 Qirsh[5] . Similarly, Ibn Qudama (Al-Mughni..) has contended that all fungibles will have to be returned in the same quantity as borrowed without consideration of appreciation or depreciation.[6]

The scheme of 'indexation' suggests that the borrower should compensate the loss suffered by the lender as a result of inflation and the consequent erosion in the purchasing power of the money. However, this may not be the responsibility of the borrower to compensate the loss to the creditor owing to a decrease in the purchasing power of the money. In the Islamic law of indemnity, the one who has caused wrong / loss to someone is responsible for redressing or compensating for that wrong / loss. Inflation and the consequent loss of value of the money of lender is never an act of the borrower. This loss would have happened even if the lender had not lent his money and kept the loaned money with him. Hence, the borrower should not be held responsible for the loss and be asked to pay any compensation.

Another aspect of lending / borrowing is that while borrowing is not encouraged, lending is considered virtuous act equated with sadaqah and in some cases even better than sadaqah. Giving qarḍ hassan to needy kin is a virtue with the relatives or friends, and in that case, requiring them to pay extra amount on the principal on account of inflation or any other reason does not make any sense. Giving loan must not be a business for getting the benefit. If one gives loan to ensure that value remains intact, he would be taking benefit vis-à-vis the money in his pocket. This aspect of seeking the benefit invokes ribā as per Islamic law.

Discussion on inflation can be concluded with the note that while interest cannot be legalized due to inflation, it is not an issue for Islamic banks that generally do not give any loan-based financing. Rasalmal' in case of loans or debts would generally mean the nominal amounts of loans or debts created except in an extraordinary case that can be decided by the court / Qādi, or the regulator. Islamic banks provide financing based on contracts such as partnership, sale and lease, and in all such contracts the impact of inflation can be covered by way of pricing the underlying goods, usufruct, or sharing profit or loss based on the principle of partnership.

In case of longer-term receivables, at individual level, as the payment of dowry or any commercial loans / debts, of course, the matter has to be decided by the family courts or through arbitration to avoid any injustice with any of the parties. Similarly, in case of demonetization, formal depreciation by monetary authorities, or announced change in the value of currency, the matter has to be decided at a macro level for just settlement of claims in such currencies.

3.3 Objective and goals of Islamic system of economics and finance

The Court (FSC, 2022) also indicated the objectives of the economic and financial system to be implemented for replacing the modern-day banking and finance. It provides:

"One of the goals of the Islamic state is to have an equitable economic system, free from exploitation and speculation. The Islamic economic system is an equitable, asset-based and risk sharing economic system. It promotes and encourages the circulation of money in the society. It discourages

5- Al Jaziri, Kitabul Fiqh, vol. 2, p. 680

6- Ibn Qudama, Al Mughni, Vol. 4, p. 325

the accumulation of wealth in few hands. Islamic economic and finance system is based on real economic activity" (para. 155).

The objective as indicated above coincides with the objectives as contended by the economists and researchers of Islamic economics and finance. These include reducing the gap between the rich and the poor as created by the interest-based system, poverty alleviation, ethical investing, promotion of social values, corporate social responsibility; environmental protection, financial stability, risk-reward sharing, and access to finance by all in any society (Obaidullah, 2005, Sairally, 2007, Asutay, 2012, Saged et al., 2017 and Hanif and Ayub, 2021).

Hanif and Ayub (2021) discussed the following goals of Islamic finance: i) Shari'ah compliance in form and substance; ii) financial stability; iii) equitable distribution of wealth; iv) financial inclusion leading to social inclusion, and v) social responsibilities.

The above objectives can be realized by properly and equitably linking the business and economy with finance while avoiding ribā, gharar, and other forms of exploitation. For this, two approaches have been recommended in the literature i) by promoting risk-sharing contracts – providing a viable alternative to the conventional debt-based financing; and ii) by using specific wealth redistribution instruments[7] [WB-IsDB, 2016, Ch. 1, by World Bank Staff; Pp 17- 40].

3.4 Guidance for alternative legal and Shari'ah governance structure

The FSC (2022) provides guidelines and parameters for the required legislation regarding laws that were challenged in the ribā case. Besides, in order to give a new direction to Islamic banks, it discussed a novel concept of ma'ālāt i.e., prospects and the end-results for conducting ijtihad and legal reasoning. The principle of ijtihad based on ma'ālāt suggests that muftis, or members of Shari'ah supervisory boards of Islamic banks should not be confined to the approval or certification of a product; they should also keep in view and monitor the post-judgement or fatwa effects and review the same, if needed. AAOIFI governance standards, GS 11 Internal Shari'ah Audit, GS 9 Shari'ah Compliance Function and others provide a comprehensive set of governance rules and practices in this context.

The other jurisprudential principle discussed by the FSC (2022) that could be observed in the process of transformation is tadāruj (gradualism). As any sudden changes could destabilize the economy and the financial system, the transformation has to be made in gradual phases. But the court did not give any details or guidance on how the tadāruj principle would be implemented. It gave 5 years' time for the transformation of the whole financial system in the country by December end 2027.[8]

Proper and planned gradualism must have some defined phases or milestones to be covered in specified time intervals. For example, the SBP might suggest to convert deposits taking by all banks, and consumers and corporate financing, micro financing to agriculture or other commodity producing sectors (on assets side) by the end June 2024, while all rupee-based banking to Islamic principles by June 2025. Conventional banking operations relating to infrastructure financing in the public sector may be done using only Islamic principles by the end of 2025. Financing for the budgetary deficit could be transformed in phases and complied to Islamic principles by December 2027. Similarly, in the capital market, the corporate sector could be advised to convert to Islamic modes for getting or investing funds. It would also require a change in financial ratios as part of the screening criteria to be considered Shari'ah compliant companies. It may be that the businesses are not allowed to use any fresh interest-bearing debt-based contract after a certain date, and to switch over completely to Islamic modes by 31 December 2027.

3.5 Is Islamic banking as being practiced based on heelah?

The FSC (2022) also dispelled the state lawyer's view that Islamic banking was not practical, or that Islamic banking as being practiced was a kind of heela (para. 80 referring to Syed Riaz ul Hasan Gilani as per Review Order 2002). But it was without going into the details about the possible use of hiyal (ruses), and the Shari'ah compliance nature or level of any such modes. The court observed:

7- For the need of the 'shared Prosperity' see WB-IDB, 2016 Chapter 1

8- The SBP, in its appeal preferred on 25th June against the FSC judgment, raised this issue and argued that 5 years' time has been fixed arbitrarily and would be insufficient to convert the debt for a duration of over five years [some instruments are even for 15 years]

"The argument of referring the activities undertaken in the name of Islamic banking as heelah is completely unfounded, baseless and unsubstantiated. The products of Islamic banking are issued by the State Banks are reviewed and approved from Shari'ah Board of the State Bank in the light of Islamic Injunctions [sic]" (P. 203, para. 90).

The court listed many assets side modes being used by Islamic banks for financing. Some such modes had already been rejected by the FSC (1991) being repugnant to Shari'ah such as buy-back, and hire purchase agreements. Similarly, sale of debts or trade bills have been prohibited not only by the FSC (1991), but also by the SBP as per the present regulatory framework.

Of course, considering the views and perceptions, or concern shown in written replies to the questionnaire circulated by the FSC in 2013, or expressed before it during the hearing, the court observed that:

"… every citizen is at liberty to challenge the legality of any such product which is being practiced and acted upon in the name of Islamic Banking. If any citizen thinks that any product of Islamic banking is not in accordance with the injunctions of Islam and the name of Islam is only being used as heelah then he can invoke the jurisdiction of the Federal Shariat Court any time. Till date, no such petition is pending before this court challenging any specific product of Islamic Banking." (P. 201-204).

3.6 The FSC's guidance on financing infrastructure and commercial projects

As per the reference guide prepared jointly by the World Bank, Pakistan Poverty Alleviation Fund (PPAF) and IsDB 2019, the FSC (P. 240-242) it is observed that some of the Islamic modes of financing could be used to convert the interest-based debt of Pakistan into Shari'ah-complaint mode of financing. The Islamic finance structures that could be used to finance infrastructure projects may include:

a) Istisnā-based financing
b) Istisnā-Ijarah-based financing
c) Wakālah-Ijarah-based financing
d) Musharakah-Istisnā-Ijarah-based financing structures

The FSC added that the government can obtain Islamic project / infrastructure financing on a bilateral basis as well as on the basis of syndicated arrangements on Shari'ah compliant modes for long term projects to build roads, motorways, dams, hospitals, housing projects etc. Musharakah-Ijarah and Diminishing Musharakah (DM) based solutions are present in the market and are being used by local as well as international banks and development finance institutions (DFIs) to finance long term projects on Shari'ah compliant modes. International Finance Corporation (IFC) and Asian Development Bank have shown keen interest, while IFC has already participated under Islamic modes in Pakistan.[9] Similarly, Islamic Development Bank (IsDB) Jeddah has provided Shari'ah complaint financing in Pakistan for longer term projects[10] (P. 246; para. 129).

Regarding the commercial finance from abroad, the Court observed that Pakistan can use working capital lines and trade finance lines on Shari'ah compliant basis to finance import of Oil, LNG and commodities under Murabaha financing facilities and Salam-based financing. Islamic Development Bank extended Murabaha-based trade lines to the Ministry of Finance in the past as well. These lines can be used to shift toward Islamic modes (para. 129).

3.7 Islamic finance and international financial institutions

As indicated by the FSC (2022), IsDB and the WB signed in October 2015 a Deep Dive Initiative (DDI), a strategic partnership framework aimed at scaling-up development assistance in common member countries. In 2016, their combined financing reached US$ 2.4 billion (US$ 910 million from IsDB and US$ 1.5 billion from WB for eight projects in agriculture (Cameroon, Sahel), agriculture and infrastructure (Indonesia), energy (Palestine, Pakistan), and water (Kyrgyzstan and Mali).

IsDB has also worked with the Asian Development Bank (ADB) to establish an equity fund under the name of Islamic Infrastructure Fund (IIF), for mobilization of public and private sector equity funds and attracting foreign investments in twelve common member states, including Pakistan [P. 208]. IsDB Group also provided funding through

9- Islamic Banking Opportunities Across Small and Medium Enterprises. Pakistan https://openknowledge.worldbank.org/handle/10986/26098?show=full

10- https://www.isdb.org/pakistan

its members: International Islamic Trade Finance Cooperation (ITFC), Islamic Solidarity Fund for Development, Islamic Cooperation for the Development of the Private Sector (ICD). Between October 2015 and December 2016 ICD delivered US$ 824 million for private sector development, financing 38 projects in 23 countries.

Regarding the IMF, the FSC observed that traditionally it focused on conventional banking systems. However, since its increased engagement with Middle East and North African (MENA) countries, the IMF considers Islamic banking to be progressively important. Having previously warned against the complexities of the Shari'ah rules, IMF now wishes to consistently apply Islamic banking rules in its functions and encourage their application in the global financial markets. The World Bank and the IMF view the growth of Islamic banking as an effort to encourage financial inclusion, stability and strength of the financial markets so that newer and resilient funding sources are created.[11]

On issuance of Sukuk, the FSC indicated that around 11,053 sukuk were issued globally amounting to over US$ 1.42 trillion from 2001 to Dec 2020. These sukuk were issued by a total of 36 countries, comprising not just Muslim majority countries like Malaysia, Turkey, Bahrain, UAE, Oman, Indonesia and Pakistan, but also include non-Muslim majority countries like USA, UK, Japan, Germany etc. (FSC, 2022, P. 216).

Accordingly, the the FSC dispelled the view that Islamic modes or Shari'ah complaint tools for international financing are not available. It observed that according to the injunctions of Islam, Pakistan is bound to fulfill any financial obligations regarding foreign debt. However, if it wants to convert those obligations from ribā-based transaction to the Shari'ah-compliant modes, then it is also possible, but only with the mutual consent of the parties.

4. Post-judgment developments and resolving issues in transformation of the system

As indicated above briefly, the SBP and some commercial banks preferred appeals before the SAB on 25 June 2022. As per Constitutional provision [Article 203D (2) (b)], the FSC judgment would not become effective until any such appeal is disposed of. The appeal has resulted in complacency, and it seems that no effective effort would be made to the accomplishment of the religious and constitutional obligation as ordered by the FSC. It is pertinent to observe that the reasons and the bases given by SBP in its appeal are almost similar to the arguments given during the review hearing by the SAB in 2002.

Financing in local and foreign currencies can be taken from banks, individually, or from syndicates, for different development and infrastructure projects. The banks might be allowed to transfer such funding to private investors also including overseas investors. As suggested by the FSC (2022, P. 207 - 209), the infrastructure, project-based and commercial financing can be taken based on Islamic modes such as Salam, Istisnā, leasing, DM, Murābaha, Istisnā- Ijarah and Wakālah-Ijarah-based financing, and Mushārakah-Istisnā-Ijarah-based financing structures.

Accordingly, the SBP should have done some initial work for implementing the judgment and then made a request to the FSC for more time. If five Islamic banks can do their business on Islamic principles, 17 conventional banks have got experience of conducting Islamic banking over the last 15 years, and the Faysal Bank has successfully shifted its entire business as per SBP's Shari'ah governance framework, then other banks could also transform fully to Islamic banking within five years.

4.1 Issues in transformation of the system and the potential

The transformation of the financial system compliant with Shari'ah is a formidable task particularly due to the huge debt taken by the government and public sector entities, from foreign as well as local sources; including National Savings Schemes (NSSs). The main argument behind the stance of the SBP in its appeal to the SAB, and the government is difficulty in transforming the domestic and foreign public debt and replacing the interest-based tools of investment used by various investors in the economy to the Islamic ones.

Pakistan's total debt and liabilities as at end June 2021 stood at Rs.47.8 trillion (100.3 % of

11- The role of Islamic Finance in enhancing financial inclusion in Organization of Islamic Cooperation (OIC) countries, Policy Research Working Paper 5920; can Islamic Banking increase financial inclusion? IMF working paper WP/15/31 2005; IMF working paper cooperation and Islamic Banking: we can learn from each other 2013 WP/13/184].

the total GDP). Total public debt from external resources amounted to US$ 95.2 billion that also included debt taken from IMF (US$7.4 billion). Public foreign debt also includes those of the PSEs amounting to US$102.2 billion (SBP, 2021) .[12]

Commercial banks are holding instruments of around Rs.12-15 trillion out of the domestic public debt of Rs.31 trillion. It constitutes around 53% of total investment portfolio of banks, although legally they are required to hold only 17-23% of their time and demand liabilities (TDLs). This debt is held in the form of 3 and 6 months T. Bills, FIBs, PIBS and other debt instruments with up to 15 years maturity.

However, there are opportunities available, provided there is will. Priorities need to be changed. Moving to Islamic finance is necessary for financial inclusion, raising the national savings rate, enhancing capital formation and to put the economy on the path of sustainable economic growth. Islamic banking has solution for short term finance as well as long term finance for all types of real sector businesses. It has successfully subscribed all government issues of Sukuk till now with an appetite for more. There are some product segments in which Islamic banks are market leaders. In many product segments in domestic finance, Islamic banking has surpassed conventional banking products. For instance, in housing finance, Islamic banking now has around 60% share of total mortgage financing. Similarly, in auto finance, Islamic banking has around one-third market share.

All categories of valid modes of business have a role to play. The trade and leasing-based contracts, as acceptable in Shari'ah, not only complement the PLS modes but also provide flexibility of choice to meet the needs of different sectors and economic agents in the society according to their risk profiles. Murābahah with lesser risk and better liquidity options have several advantages for banks vis-à-vis other techniques, though may not be as fruitful in reducing income inequalities and generation of capital goods, as the leasing and participatory techniques. Yet, if applied properly they can be helpful in employment generation and alleviation poverty.

Ijārah related financing that requires Islamic banks and financial institutions (IBFIs) to purchase and maintain the assets and later dispose of them according to Shari›ah rules, requires the banks to engage in activities beyond financial intermediation. Leasing can be very much conducive to the formation of fixed assets and medium and long-term investments. This can help in capital formation in the economy and the DFIs may resort to this mode for financing of development activities.

Salam has a vast potential in financing productive activities in crucial sectors, particularly agriculture, agro-based industries, and the rural economy. It also provides incentive to enhance production. Since the seller in Salam gets the price in advance, he will spare no effort in producing, at least the quantity needed for settlement of the amount of funds taken by him. Salam can also lead to creating a stable commodities market, especially the seasonal commodities and therefore to the stability of their prices. It would also enable savers to direct their savings to investment outlets without waiting. For instance, until the harvesting time of agricultural products, or the time when they need industrial goods and without being forced to spend their savings on consumption.

In the capital market, time-bound equity in the form of possible corporate sukuk and open and close-ended mutual funds, Mudarabas and Shari'ah-based equity and venture capital funds offer huge potential for promoting Islamic capital market. Islamic finance experts are leading in product variety and innovation. Currently, Islamic mutual funds have almost one-half share of the funds market. In some mutual fund categories, Islamic mutual funds are virtually leading the market.

5. Need for addressing the weaknesses of the Islamic finance industry

Although the FSC dispelled the impression that Islamic banking in practice is based on any kinds of heelas (P. 189; para. 80), yet it remarked that anyone could approach the FSC if one feels that any mode(s) used by Islamic banks are based on heelah. Hence, the Islamic banks need to address the weaknesses in terms of Shari'ah compliance lest the court declare any product as not conforming to Islamic principles, as it did in respect of some products in 1991..

The banks need to ensure Shari'ah compliance of their business both in form in substance if they wish to enhance their outreach to the whole population of the country. There could be many

12- https://www.sbp.org.pk/reports/stat_reviews/Bulletin/2021/Sep/Domestic%20and%20External%20Debt.pdf issues arising from the use of some grey area products like organized Tawarruq, currency Salam, running Musharakah and sale of near-to-maturity GOP Ijarah sukuk to SBP (Mansuri, 2020). As suggested by the FSC, Islamic banks must consider the end-results (ma'alāt) of financing activities for realizing Shari'ah compliance in spirit, and for desired socio-economic impacts. It would require a paradigm shift in the policy and the direction of Islamic banking – to serve as business and trade intermediaries, rather than earning money from money.

For transforming the corporate finance system, the financial ratios used for screening criteria for Shari'ah compliant companies have to be changed. The provision of having interest-based debt in the criteria for Shari'ah compliant companies may be phased out gradually by the end of December 2027. Such phasing can be planned jointly by the SBP, SECP, Ministry of Finance and other state institutions in consultation with the Pakistan Banks Association (PBA) and the Business and Industry Chambers in the country.

The research centers, universities and business schools need to undertake R&D work in collaboration with the banks, the financial market regulators and the chambers of commerce and industry in the country. Universities may undertake survey for profit margins and rental rates in various sectors and businesses at local and national levels. They need to work on developing benchmark rates for financing main sectors in the economy based on the market rates for various sectors and transactions. They may also prepare illustrations of various banking and finance transactions so that the same could be Shari'ah compliant in spirit, and helpful in social justice. They may also review the instruments and products approved by Shari'ah boards and implemented by banks for problem resolution. The R&D centers may also provide practical suggestions for the Parliament, Shari'ah Court, and higher judiciary, as and when required. For capacity building, they may provide training and orientation for professionals, Shari'ah board and BOD members of banks, product developers, and middle & senior-level practitioners.

5.1 Providing proper legal framework for functioning of the system

Islamic banking in Pakistan needs to have a better developed and sound legal cover. Some changes were made in 1980s in the Banking Companies Ordinance (BCO, 1962), Companies Act, etc. but without any specific law. For transforming the system, there has to be a dedicated and a comprehensive primary law for Islamic banking and finance similar to the laws present in Malaysia, Sudan and Iran, where the industry is governed by a separate law.

The Commission for Transformation of the Financial System (CTFS) established in SBP as per Directives of the SAB judgment (1999) proposed in its report (2001) one comprehensive seminal law namely, 'Islamization of Financial Transactions Ordinance'. The Task Force (headed by late Dr. Mahmood Ahmad Ghazi) that was constituted at the Ministry of Law in pursuance of the SAB's judgment had suggested two separate ordinances namely 'Prohibition of Ribā Ordinance' and the 'Financial Transactions Ordinance'. While the former would be a main law for the prohibition of ribā, the latter would serve as ancillary rules on foreclosure and fair trade and business practices (Janjua, 2004).

Providing alternative law and legal framework for Islamic financial system is a crucial task that has to be accomplished as a pre-condition for the transformation process. Work on this aspect has to be done at the ministry of law, SBP, SECP and the Parliament that may take much time. All stakeholders need to be on board for preparing a suitable legal framework for proper functioning of the new system. Inclusion of robust industry standards issued by standards setting institutions such as AAOIFI and IFSB must be incorporated into these laws.

5.2 Moving to shared and broad-based growth paradigm

The continuing crises in the global economy must inspire IBFIs to follow a different paradigm. To properly relate finance to the real sector, Islamic banks need to explore such modes and instruments that could play role in promoting the real economy. Forward sale and creating financial assets based on potential growth in goods and services is valid only when it is subjected to the conditions imposed for valid Salam and Istisnā transactions. It refers to the need for controlling money and credit in national economies and global finance. Inflation targeting, monetary policy, and its management have to be geared to ensure that financial flows are just sufficient to facilitate the growth of the real sector, and exchange of goods and services. It could be accomplished partially at the OIC level by involving the IsDB or any apex forum like the COMCEC of the OIC.

SBP as a regulator, and banks as Islamic financial intermediaries need to move from the current paradigm of legal compliance for maximizing the shareholders' value to the paradigm of value oriented shared and broad-based growth. It is a requirement of the natural system of co-existence and social inclusion, as also of the goals set out under the United Nation's Sustainable Development Goals 2030.

The paradigm changes as suggested above must be on both liabilities / deposits and the assets / financing sides. The deposits management and profits distribution system as introduced by the SBP involves assigning weightages, the basis of which has to be changed. The current system of assigning weightages to deposits facilitates the banks to offer higher rates to 'priority deposits' at the cost of the common depositors. Although SBP's Shari'ah governance framework prohibits banks to give gift (hibah) from their own share to any individual account holders in a deposits pool, but the banks have created many pools - separate for a single big depositor particularly in case of 'Special Mushārakah Certificates' (SMCs) innovated by Islamic banks to circumvent the restriction imposed by the SBP. Currently, profits given by Islamic banks and Islamic banking systems of conventional banks are almost half of the interest given by the conventional banks, as could be seen in the Table 1.

Table 1. Profit rates on Islamic and conventional remunerative deposits

Panel A: Profit rate on deposits (%) Dec 2021					
Bank name	**Savings**	**TD 1 year**	**TD 2 years**	**TD 3 years**	**TD 5 years**
Meezan Bank	4.00	6.11	6.78	6.78	6.78
Bank Islami	5.50	5.25	5.30	5.35	6.08
Dubai Islamic	4.50	5.35	5.85	6.00	6.25
Bank Al Baraka	3.50	7.25	7.30	7.50	8.00
MCB Islamic	4.00	4.42	4.42	4.51	4.53
HBL Islamic	4.04	5.04		5.55	6.05
UBL Ameen	3.00	3.20	3.80	3.85	4.35
Bank Alfalah Islamic	2.45	5.41	5.42	5.47	5.54
Average	3.87	5.25	5.55	5.63	5.95
Panel B: Interest rate on deposit (%) Dec 2021 / Jan 2022					
Bank name	**Savings**	**TD 1 year**	**TD 2 years**	**TD 3 years**	**TD 5 years**
Habib Bank	8.25	10.90	11.00	11.50	13.20
United Bank	8.25	9.11	9.15	9.16	10.06
MCB Bank	8.25	7.55	7.94	825	8.91
Allied Bank	8.25	6.25	6.25	6.25	6.25
Bank Alfalah	8.25	9.05	10.29	10.25	10.32
Bank Al Habib	8.25	9.55	9.65	9.75	10.00
Askari Bank	8.25	9.00	9.00	9.25	9.25
JS Bank	8.25	9.00	9.50	9.50	9.75
Average	8.25	8.80	9.07	9.24	9.72

Source: Banks' websites

This system that creates injustice in profit distribution and unfair treatment with common / small depositors will have to be changed to the effect that all weights must be 1 (unit) when added, as given in the second box, for example. It will reduce the maneuvering capacity of the banks. Increasing weightage for one category would mean decreasing the weight for other categories.

The pool management system must ensure that i) smaller deposits of any tenor are not assigned

Savings a/c	0.15
3 months	0.16
6 months	0.20
1 year	0.22
5 year	0.27
Total	1.00

lower weightages irrespective of the size of the account, ii) assets of the general or other pools are not shifted to other pools just to give (agreed) higher return to priority deposits, iii) Islamic banks may be subjected to special investigation in case profits they give to any category of depositors are relatively less than their earnings, while the shareholders get high profits, and the BOD members and executive management draw hefty packages / bonuses and perks. Another suggestion is that the minimum profit given by any Islamic bank must be based on the weighted average return of the entire asset class net of provisioning. It would enable the depositors to bear the risk of provisioning, while they will also get higher returns.

6. Summary and conclusion

The banking and financial system in Pakistan was Islamized by 30 June 1985 (Janjua, 2003). However, the banks resorted mainly to the sale and buy-back and trading in receivables. Careless application of Murābaha and other Islamic modes rendered the NIB system un-Islamic (FSC, 1991). The focus of the government and the SBP turned to the process of trial and retrial of ribā in Shariat courts that culminated into the FSC (2022) judgment. But again, the SBP and some banks, even those banks that are operating standalone system of Islamic banking, went onto appeal to the Supreme Court, and hence, the effectiveness of the judgment was postponed till the appeals are disposed of, which might take decades, as it happened in the past.

Although Islamic banking attained a good share of 20% in the banking system of the country, but it reflected slower pace of getting increasing share in country's banking over the period of 20 years, while 97% of the population are Muslims. Partly, it might be due to the 'integrity gap' that is widening day by day due mainly to the reason that the Islamic banks ignore the substance, and that the regulator agreed to the paradigm of only the legal compliance and form. It made a large part of the society undecisive and undetermined to move to Islamic banking system and, therefore, the objective of transformation of the entire economy ended-up in complacency.

The increasingly unmanageable debt stock and the problems emanating from this for the common man and the economy required that the government and the SBP initiated the process by moving to Islamic banking at national level within a couple of years. In unavoidable cases relating to banks investments for public sector financing, more time could be required. But preferring appeals based on points almost like the points raised 20 years back is not justifiable in any way.

There are some Shari›ah acknowledged norms and values in the context of Islamic finance. If these values are violated and resultantly the same injustice, exploitation, and concentration of wealth as in the case of conventional banks persist, it would only mean that Shari›ah has not been observed in its true spirit.

To ensure the positive role of Islamic finance in the development of the economy and shared growth, risk sharing modes can be used for short, medium, and long-term project financing, import financing, pre-shipment export financing, working capital financing, and financing of all single transactions. It could be possible by promoting venture capital, mutual funds, and project-based crowdfunding. Shari'ah scholars must guide the government and the regulators of financial markets while ensuring that the objective of transformation as indicated by the FSC (para. 155) is realized, and the economy and the people of the Islamic Republic of Pakistan get rid of ribā both in form and substance.

All participatory, exchange contracts and agency-based Islamic modes can serve the purpose of linking the real economy to finance and develop the economy. Of course, the IBFIs need to use them while observing their Shari›ah essentials in letter and spirit. Tawarruq, for example, could be used only in extreme cases strictly in line with AAOIFI's standards.

As suggested by the FSC (2022) in respect of financing by the WB and IsDB, all infrastructure and project based and public sector commercial financing can be taken based on Islamic modes like Salam, Istisnā, leasing, DM, Murābahah, Istisnā–Ijarah and Wakālah–Ijarah based financing, and Mushārakah-Istisnā-ijarah based financing structures. "The World Bank and the IMF view the growth of Islamic banking as an effort to encourage inclusion, stability, and strength of the financial markets so that newer and resilient funding sources can be created", the FSC remarks (P. 211-212).

The Islamic banking industry has a vast scope for employment generation particularly if it encourages and finances the entrepreneurs in SME and micro business sectors. Further, Islamic finance is a part of the Islamic economic system the very basis of which revolves around justice and morality. Therefore, all-out efforts need to be made by the government, the religious and political leadership, Shari'ah scholars associated with the banks and intelligentsia in general for enhancing the ethical business norms in the country.

The framework suggested for Pakistan could also be applicable to other OIC member countries in case they wish to transform their whole system to Islamic principles, with some changes specific to every economy. It's particularly required for such economies that have the tendency of incurring debt-based public finance from national or foreign sources.

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Technical article

Islamic finance: Potential for accommodating ESG as an additional layer of governance

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If a group of individuals who have never heard of Islamic finance were asked the question: Please describe what is Islamic finance? The majority would likely conclude, it is a form of socially responsible or ethical finance. Those with a more academic leaning in the group will mention that Islamic finance is a form of finance governed by Shari'ah. Were the same group, then asked a further question: What is ESG? They may answer, ESG is environmental, social and governance, underpinned by principles of being a good steward to society and the environment. Therefore, with more similarities than differences, it then begs to ask the question, why has Islamic finance not accommodated ESG as an additional layer of governance?

For years, Islamic finance practitioners, have had countless roundtable discussions and argued at length that there is much in common between Islamic finance and ESG. The crux of this article contends that ESG aligns naturally to Islamic finance. It makes the point that the time has now come for Islamic finance Institutions (IFIs) to take the lead to harness the potential that arises from this convergence, and this may be accomplished by the regulators as a part of overseeing IFIs' corporate and Shariah governance. It analyses the responsibility of market regulators, the need for policymaking and implementing ESG as a regulatory concern, it discusses the historical barriers as to why ESG has not been adopted, and suggests ways it can be.

A natural role for ESG in Islamic finance

Inherently, environmental stewardship, sustainability and good governance are part of Islam. The Holy Qur'an and sunnah of the Holy Prophet (PBUH) contain evidence in support of this.

The Holy Qur'an states in Surah Al-An'am: "It is He who made you the vicegerents of the earth and raised some of you in ranks over others, so that He may test you in what He has given you. Surely, your Lord is swift in punishing, and surely He is Most-Forgiving, Very-Merciful"[4](6:165).

The Holy Prophet (PBUH) was a pioneer when it came to preservation of land and providing sanctuary for the wildlife. He designated special areas solely for water, wildlife, and forestry. He taught that animals, land, water and the eco-system are provisions from Allah (SWT) to use in moderation and with wisdom.

Islam conceptually and in action endorses many ideals which form the basis of ESG. Islam calls for ethical and moral practices to be part of everyday life with activities causing social detriment prohibited for Muslims to engage in.

Islamic finance and ESG are complementary in capital-raising and investment approaches, with shared underlying principles, such as not investing in gambling (qimar), tobacco, weapons,

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pornography, and other activities which are harmful to society. Islamic finance products are negatively screened to avoid such prohibited industries. Equally, ESG investing avoids certain industries and harmful products, such as alcohol, tobacco and nuclear energy, along with those companies engaged in human rights abuses such as child labour. ESG portfolios are also aligned to the value of their clients and have the overarching goals of developing a sustainable society thereby causing minimal or no harm to people and the environment. At the core of Islamic finance and ESG, there is deep rooted principles of stewardship. Both strive to make the world better for everyone and require an underlying sense of social justice and an understanding that transactions have a social impact. Islamic finance, in its essence, is sustainable finance, supported by a legitimate underlying transaction, formalised via an 'aqad' as approved in Islamic commercial law.

Islamic finance and ESG can, if structured correctly, complement each other. IFIs need to be aware of this alignment with ESG and adopt the complementary elements of ESG to integrate within their systems and processes. IFIs should be taking the lead with ESG in the pursuit of creating a just financial system. In the coming years there will be ample opportunities for social finance as the world deals with the fallout from the Covid-19 pandemic. Therefore, IFIs should understand they are not competing with ESG, rather that ESG is complementary in nature and when ESG principles gain more traction, so will Islamic finance. IFIs can use the complimentary aspects of ESG to market Islamic finance to a new pool of investors.

Why hasn't there historically been more of an ESG component with IFIs?

The stark reality is that a number of IFIs do not have carefully thought-out ESG policies in place and lag behind their conventional counterparts. Until recently, there was little appetite from IFI›s to include ESG in their screening criteria.

There is an argument that the low uptake of ESG by IFIs owes to geography rather than appetite. If we look at the historical trends within the debt finance sphere, products and trends tend to develop in the London or New York markets. Consequently, such products find their way to the Middle Eastern markets after considerable time. For example, in the London market, nearly all leveraged finance transactions taking place currently will have an element of sustainability metrics attached; however, in the Middle East, this is not yet the case.

Additionally, it may be that the lag time is attributable to the type of investors based in the Middle East, who tend to rely upon natural resources and therefore are less attracted to ESG principles. Fundamentally, there is nothing to stop IFIs from ‹bolting on› ESG screening, like some conventional institutions do, as there will likely be some overlap between investors looking at deals in the ESG space and those interested in Shari'ah compliant ESG products.

Another stumbling block is that many IFIs based in the GCC view ESG principles as synonymous with CSR, which they may have either already incorporated or do not feel necessary to do so. This attitude, therefore, tends to perpetuate the cycle in the Middle Eastern markets.

With ESG reporting by corporates becoming more commonplace and mandatory, there will be a demand for IFIs to include an element of ESG metrics in their screening processes. This will inevitably happen as governments and regulatory bodies look towards sustainability. Therefore, there will be pressure from major corporates demanding IFIs to incorporate ESG.

While there has not been much convergence to date, there will be inevitable alignment between Islamic finance and ESG, with similarities in risk appetite. At present, there is not much ESG in the mainstream Islamic finance market, apart from an number of green and sustainable sukuk. However, there have been innovative transactions, in Malaysia, and Indonesia. This is due to the efforts of the regulators in these jurisdictions, making the adoption of ESG standards easier for IFIs.

Role of regulators

With IFIs primarily operating in a regulatory environment built around conventional institutions and their activities, IFIs from the outset do not compete on a level-playing field. Consequently, regulation can either be a barrier to ESG adoption for IFIs or be used to drive growth for ESG implementation. Regulators in the GCC might not be able to provide the same types of ESG incentives found in European markets, but they can focus on reducing the implementation cost to IFIs and investors. For example, in the context of green sukuk, GCC regulators could look towards Malaysia where the costs of third-party checks for issuers of Substantiable Responsible Investment

(SRI) sukuk is paid for by the government.

As companies across the GCC become more attuned to ESG requirements, regulators can increase disclosure requirements for sukuk issuers on ESG, this would add to more ESG integration by investors and help IFIs, in particular those based in the Middle East, with ESG reporting.

Another driving force to implement ESG must come directly from the stock exchanges in the GCC, particularly those who have signed up to the Sustainable Stock Exchange (SSE) initiative for a number of years, with Dubai Financial Markets (DFM) joining in 2016, the Saudi Exchange in 2018, and the Bahrain Bourse in 2019. These stock exchanges must now play a vital role as they are well-placed to connect national markets to global ESG investment and can build capacity by promoting ESG standards, products and practices. They can drive increased reporting for those companies listed on them, as well as issue more supplementary guidance on ESG reporting and raise awareness. This will no doubt, result in investors having more ESG data, which will demonstrate a commitment to ESG and attract attention from investors around the world.

Within the last couple of years, we have now seen the stock exchanges in the GCC providing ESG disclosure guidance to encourage and assist listed issuers in providing ESG reporting. This is primarily because the decisions and practices that investors take on the GCC stock exchanges will have a direct bearing on some GCC states in meeting the targets set out in the United Nations Sustainable Development Goals (UNSDGs).

Regulators can also encourage IFIs in establishing how they report data for ESG considerations. IFIs should be encouraged or even incentivised to sign up to the Principles for Responsible Investment (PRI). Regulators should take the lead and work in tandem with PRI to create a more suitable reporting framework for IFIs. PRI, although acknowledged in Europe, does not carry the same standing in the Middle Eastern and Asian jurisdictions. As ESG reporting in the Islamic finance sector is at an embryonic stage, the lack of standardisation and understanding of ESG still stands in the way of meaningful reporting.

If regulators across the Middle Eastern and Asian jurisdictions are serious about long-term sustainability goals and the incorporation of ESG principles, more IFIs need to be encouraged to sign up to PRI and a culture for ESG needs to be created. Where local demand is not driving ESG, the onus should be on regulators to focus on ESG and create an environment for IFIs to make the adoption of ESG standards easier.

In recent years, there have been initiatives and innovative structures that align with ESG. By way of example, the Securities Commission Malaysia introduced the Sustainable Investment Sukuk Framework in 2014 and the issuance of the world›s first green sukuk by Khazanah Nasional Berhad in 2017. Since then, Malaysia has gone on to introduce the SRI sukuk roadmap and has introduced grants to cover the cost of SRI. Likewise, Indonesia›s Financial Services Authority (OJK) published a roadmap for sustainable financing in 2014 and the Ministry of Finance issued a green sukuk in 2018.

Whilst the regulators across the GCC are also looking into smoother assimilation of ESG standards into the business of financial institutions, ESG principles and innovative structures like green sukuk are still in their infancy compared to their Asian counterparts. However, with Saudi Arabia now implementing guidelines on sustainability finance in a bid to achieve its Vision 2030, it is hoped this will be the catalyst in the GCC to drive ESG.

There will be more Shari'ah compliant ESG products, funds and sukuks launched in the coming years. However, to unlock long-term investment trajectories and new business opportunities, regulators in the Middle Eastern and Asian jurisdictions must be willing to be at the forefront to create uniformity of standards for ESG which in turn will bring about scalability and industry effectiveness, thereby improving international confidence.

The increasing demand for ESG from international investors and clients is a powerful driving force, but it will not be enough, there must be a real willingness for regulators, especially those in the Middle Eastern and Asian jurisdictions, to raise awareness around ESG and augment the spread of an ESG culture across the industry.

Role of the Shari'ah scholars

Shari'ah scholars might not be able to make decisions as to whether IFIs will or should adopt EGS standards in most cases. They, however, have an integral role in reviewing and approving all the Shari'ah aspects of a transaction. Shari'ah scholars can demand that IFIs adopt some of the basic ESG standards or recommend on-going compliance in their fatāwā. They are in a prime position to raise awareness and support IFIs with in-house training to assist in streamlining integration between Islamic finance and ESG principles so that products and transactions do not just meet Shari'ah compliance but also work towards achieving the maqasīd-al-Shari'ah.

Why IFIs now need to take the lead with ESG to harness it's potential?

First, a higher purpose underpinning the Islamic finance sector should be a pursuit of a just financial system and IFIs adopting ESG is a step in that direction. Second, this presents an opportunity for IFIs to develop unique products differentiating from the current Islamic finance products in the market, and in doing so, striving one step closer to meet the maqasīd-al-Shari'ah.

The price or value of products and services offered or invested in IFIs should take into consideration the harm caused by these products or services on society, the environment, and the economy. For example, considerations such as whether the price of the facility agreement should account for the economic loss suffered by workers of an obligor, if they are not paid fair wages. IFIs will truly distinguish themselves and enhance their reputation if they combined an extra layer of ESG governance with Shari'ah compliance.

Prophet Mohammed PBUH said, «Even if the Resurrection were established upon one of you while he has in his hand a sapling, let him plant it» (Musnad Ahmād)

With Islamic finance continuing to grow exponentially, there is a unique opportunity for IFIs to meet ESG standards to drive sustainable investment. For instance, the United Nations Principles for Responsible Banking Framework (UNPRBF) predicts that more and more institutions will get on board the net-zero carbon emissions movement.

When looking at the annals of history, Shari'ah and ethics were not viewed separately but were interwoven. There existed the spirit of Islamic values, which were the hallmark of any transaction, where the contracting parties mutually benefited. After the inception of the first Islamic bank in the 1960s, the main focus for IFIs was to obtain Shari'ah certification, thereby, allowing Muslims an alternative to conventional finance. As Islamic finance blossoms and matures the Shari'ah compliance and screening process needs to seamlessly embed ESG standards and practices within its functions.

As Islamic finance practitioners we should work towards the creation of a sector encompassing Islamic values and ethics. The adoption of Shari'ah compliant ESG metrics could be the next stage in the development of Islamic finance and IFIs thus creating a sector which produces transactions imbued in Islamic ethics and spirit. Islamic finance which converges with ESG and backed with Islamic ethics will mean that IFIs will not just be viewed as mere intermediaries but institutions that generate good in society. It will also be a further step in differentiating from conventional institutions and for Islamic finance sector to be remoulded in line with the spirit of Shari'ah in their transactions.

As positive screening becomes more widespread in Islamic finance, there will need to be a concerted effort from all those involved in the Islamic finance sector to make this happen, from regulators, Shari'ah scholars, bankers, through to academics and lawyers. Everyone must beat the same drum, this is the only way to set a new criteria and benchmark for positive screening in the Islamic finance sector.

IFIs can have an important role to play in bridging the financing gap for the UNSDGs. It is estimated (according to the UN's World Investment Report) between USD3.3 - 4.5 trillion annually will need to be mobilized to achieve the UNSDGs. Developing countries face an annual funding gap of USD2.5 trillion to achieve the UNSDG and need to increase public expenditure to fill this funding gap.

As Islamic finance continues to adopt more sustainability criteria, with developing countries needing a full suite of financing to meet funding gaps, Islamic finance is well placed to maximise social impact and address the UNSDGs target for such countries.

How can IFIs adopt ESG?

IFIs could start with a few sustainability linked Key Performance Indicators (KPIs) and then look to increase this over time. In ESG, transactions are vetted by ESG experts, a process that will be familiar to IFIs. IFIs are accustomed to structuring around principles and undertaking negative screening and therefore well-placed to take the lead in ESG. There will need to be collaboration between regulators and IFIs to set the tone to drive ESG forward.

ESG is at an embryonic stage and there will initially be an additional burden of structuring and costs. Such additional work and costs should not be daunting to IFIs as they can learn to share costs with the ultimate beneficiaries if they can demonstrate tangible benefits. The benefits of ESG outweigh the additional work required as the demand for Shari'ah-compliant ESG products is projected to grow. IFIs already go through a Shari'ah review process to ensure that products and transactions are compliant. Therefore, incorporating ESG KPIs to existing screening criteria should not be particularly burdensome.

Islamic investors can include an assessment of their IFI's compliance by using AAOIFI CSR standard in their investment analysis, they can include metrics between corporations and their employees, customers and suppliers, which in turn, will put them in compliance with the norm-based standards used in ESG investing. The overlap of IFIs using CSR screens and ESG norm-based screens can be a way for IFIs to start incorporating ESG. Islamic finance will also benefit from the typical ESG investor who will enter the sector and introduce sturdier disclosure requirements, more transparency, and overall better corporate governance. Islamic leverage screens could also boost performance as ESG investors become more involved in the emerging markets. The most effective and easiest way of achieving this is to include ESG as a ‹bolt on› complimenting the existing Shari'ah compliance screening by adding a new dimension of ESG compliance.

There are IFIs who have started to create offerings which are Shari'ah compliant and consider ESG considerations. For example, the DDCAP Group incorporates ESG with regards to commodities transactions facilitated through their ETHOS AFPTM platform. This is because of stakeholders' expectations around Shari'ah governance and counterparties becoming more attuned to environmental and social impact concerns. The DDCAP Group›s approach looks at the commodity used and the protocols surrounding the transactions it facilitates.

Furthermore, BIMB Investment introduced sustainability to its data-driven selection process for its Islamic ESG fund and has since introduced three additional ESG funds. As an Islamic Fund manager, BIMB was quick to note that ESG factors were becoming mainstream and there was an opportunity to integrate ESG into its investment process. Further, with ESG now becoming a trend, Sedco Capital recognised this growing overlap between Shari'ah compliance and ESG, to become the first Shari'ah compliant asset manager in Saudi Arabia to be a signatory to PRI.

To conclude, Islamic finance and ESG - if structured correctly - complement each other and as the focus on ESG increases, IFIs need to harness the potential arising from this confluence by appealing to new pools of investors and differentiating products so that they are imbued with more Islamic ethics and spirit. One way is for the IFIs to have a ‹bolt on› approach which compliments their existing screening criteria.

The stage is now set for Islamic finance to take the next step in its development and go beyond a narrow view of Shari'ah compliance to demonstrate to the world that Islamic finance has a positive social impact. IFIs will have an important role to play in this, as they can bridge the gap for developing countries to meet the UNSDGs. However, the regulators also have their part to play and need to promote ESG further to create the environments to make adoption easier. As Islamic finance continues to grow in line with the global economy and there is an increasing emphasis on ESG, it is now prudent for Islamic finance to take the lead across its asset classes by accommodating ESG as an additional layer of governance not only to meet the Maqasid-al-Shari'ah but to discover new business opportunities and develop the sector.

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Technical article

Deposit insurance scheme in Islamic banking: An analysis

Dr. Ahmed Omar Abdalleh[1]

1. Introduction

Deposit protection scheme, an important auxiliary tool for financial institutions, is not commonly known among many practitioners and stakeholders in the Islamic financial industry. The scheme has originated from the conventional banking system. The article looks at its applicability to the Islamic banking institutions and discusses some examples and models thereof.

The relationship between the bank and the customer on deposit account (particularly current account) has mostly been characterized as a loan contract i.e., creditor-debtor, be it from conventional perspective or from the practices of Islamic banks. There could be a risk for the depositor in case the bank goes into liquidation due to any business or market related circumstances. In the event the bank goes bankrupt, the priority of claim is given to the secured creditors, the depositors are treated as unsecured creditors. One traditional way to mitigate such risk for the depositors is through any deposit protection / insurance scheme. It provides a safety net in the system that strengthens depositors' confidence in the system.

The rationale for risk management system from the Islamic perspective is that Islam has accorded utmost importance to the protection of wealth. In the Holy Quran, Allah SWT says: "Do not give the feeble-minded your property that Allah has made a means of support for you, and do feed them from it, and clothe them, and speak to them in fair words." (4:5). For the same reason, that is the protection of wealth, Allah SWT has condemned the wealth's wasteful spenders in the Qur'an. Allah says: Surely, squanderers are brothers of Satans, and the Satan is very ungrateful to his Lord" (17:27). Therefore, any deposit protection scheme that does not involve any prohibited factor is a legitimate tool for wealth protection. In Islamic perspective, we may call it 'Deposits Takaful System' (DTS). This article covers the history and development of the deposit insurance system (DIS) and the protection could be provided in Shariah compliant way to call it DTS.

The justification of any DIS rests to a large extent on its effectiveness in averting systemic banking crises and contagious bank runs due to failure of any bank(s). Many countries established deposit insurance schemes after banking financial crises in the past with the objective to prevent any such crises in future. A well-known example is the United States (US) Federal Deposit Insurance Corporation (FDIC), which was set up after the US experienced massive bank failures during the Great Depression (1930s).

The development of the modern banking system came with its own risks and periodic market crises. In the past, losses in business were a natural outcome of the market performance, there were no banks, and the world markets were not interconnected, so even if trade loses happened somewhere, it could only affect the small number of people directly connected with the particular trade. The modern market is more sensitive and much interconnected. If anything goes wrong in the West, the rest of the markets in the world could be affected in a matter of minutes. The effect would not be confined to the banks and

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the economies and particularly the old pensioner, poor people and the stall operators maintaining small deposit accounts with the banks could be affected.

In the past two decades, in a series of banking crises around the world, some banks became systematically insolvent both in developed and developing economies. To make such financial system breakdowns less likely and to limit the costs when it occurs, the need for financial safety nets cannot be overemphasised. The policymakers must adopt policies towards that goal, which include such policies as implicit or explicit as deposit insurance, a lender of last resort function of the central bank and proper banking regulation and supervision.

Establishing an explicit deposit insurance scheme became part of the generally accepted best practice advice given to the developing economies.[2] A World Bank survey on bank supervision in 2007 showed that about 70 percent of high-income countries and half of upper middle-income countries had deposit insurance scheme in place.

2. Objectives of any deposit insurance scheme

This scheme has been defined as an insurance system supported by the insured banks themselves and administered either through a government-controlled agency or a privately held entity.[3] The rational or the overall objective of this scheme can be summarized as follows:

a. it is used as a financial stabilization tool; and

b. it is used as a tool of competitive efficiency.

The detailed objectives of any such scheme may include the following:

i. to protect individual depositors - it guarantees the payment of deposits up to certain amount in the event of bank closure. It pays depositors promptly instead of waiting for the liquidation of bank assets before their claims can be honoured.

ii. to prevent bank runs - it provides depositor confidence and protects bank runs It may however not guarantee 100% protection, but at least some reasonable percentage of their deposits.

iii. to promote stability - it provides economic stability in general. As banks are one of the main movers of the economy, their stability contributes to the stability of the economy, and bank deposit insurance scheme is to ensure the stability banking system.

3. Implementation of deposit insurance scheme

The modus operandi of the scheme has the following features.[4]

a. membership - the scheme's membership could either be compulsory or voluntary depending on the country›s way of implementation. In the US it is compulsory for the major banks to join the scheme since the controller of the currency and the Federal Reserve require their members to join the FDIC. In Germany, it is voluntary for private commercial banks. In Philippines, the membership is compulsory for all banks. In Malaysia, the membership is compulsory to all financial institutions licensed under the Banking and Financial Institutions Act 1989 (BAFIA) and Islamic Financial Services Act 2013 (FSA). Although the two (i.e., voluntary and compulsory) models exist in different countries, it could be argued that, making the membership compulsory would probably be the best option given the volatility of the market, and how it would affect the country's stability in the event of crisis.

b. coverage - in most countries the coverage is limited, but in Germany the coverage is unlimited. Some have criticized the unlimited coverage of deposit and argued that when deposits are 100% insured, the banks could be very risk prone. However, the benefits could be more than the potential risks.

c. administration – the administration of deposit insurance corporation also depends on the practice of each country which has this scheme. In the US, the Philippines, and England it is administrated by official government bodies. In Germany, it is privately administrated.

4. Funding for the scheme

The scheme is funded primarily from the premiums and the contributions of member

2- http://wber.oxfordjournals.org/cgi/content/abstract/15/3/481

3- Maria L Fres-Felix, (1991). deposit insurance schemes (its nature, roles and issues) the south East Asian Central banks research and training centre, Kuala Lumpur, Malaysia,

4- Maria L Fres-Felix, (1991). deposit insurance schemes (its nature, roles and issues) the south East Asian Central banks research and training centre, Kuala Lumpur, Malaysia,.

institutions. Sometimes the government can inject some money when it sees it necessary to do so, like the case of Türkiye. There are, however, some arguments against the authority involvement in funding the scheme. The argument is that by bearing part of the cost of deposit insurance, the authority may have contributed to some of the failures through their policy measures.[5]

5. Issues in deposit insurance

The deposit insurance as it is developed has also some issues that need to be analysed and understood as follows:

a. determining the level of insurance – majority of the deposit insurance schemes have a limit of coverage. This limitation is seen differently, some have argued against it saying that this limited coverage could be at times unlimited. Take the example of US, which has the limit of US$100,000. They argued that there are cases when deposit balance over and above US$100,000 have been ensured because of the (too big to fail) policy. Their contention is that it could give bank deposits competitive advantage over investment banks. Therefore, they said that there is a need to limit deposit insurance, because its main objective is to provide protection to all depositors.[6]
b. The pricing of insurance issue – On what basis the pricing or determining the premium is based on? Should it be flat rate? Would it be fair or equitable for all banks? Should it be based on the level of risk exposure? These questions need to be addressed to make sure the fairness of the system. The probable fair method can be that the corporation assesses the amount of deposits which a particular institution has, and thereafter determine the amount or the percentage which the bank must contribute, so that the premium amount reflects the size of the contributing bank.

6. Some models for Islamic deposit protection scheme and its legal characterisation

The objectives of the deposit insurance scheme are the same weather it is Islamic or conventional bank. The reliability and robustness of the system is necessary to remain competitive and to provide Shari'ah compliant alternative to the society. The arrangement of the scheme and the type of coverage provided in it, and types of deposits to be protected are open for discussion and debate.

In Malaysia, the approval for the establishment of the deposit protection scheme was given by the Shariah Advisory Council (SAC) of Bank Negara Malaysia. The SAC resolved that deposit insurance scheme in Islamic banking is permissible based on the concept of mutual guarantee among the Islamic financial institution as participants to the scheme.

Nevertheless, there is a need to separate the funds in the operation of deposit takaful scheme for Islamic banking to ensure that the funds of DTS are invested in Shariah compliant instrument.[7] In Islamic banking there are two characterization of deposits, current account which is based on Qard and the Investment account which is based on Mudarabah. Some argued that in Mudarabah the nature and the condition of the contract are against the protection notion.[8] The protection is against the nature of the investment-based deposit, if the bank is the one providing the protection. However, the deposit insurance scheme does not provide protection against investment risks, therefore it should not be an issue here, and the guarantee provided by the deposit insurance corporation is considered a third-party protection.

In Sudan, the government has established a special fund for deposit protection. The idea of establishing the fund has been there since 1984, and there have been enormous modifications to cope with the procedures of converting banking system to be in line with the Islamic principles. The deposit protection for Islamic banks was endorsed by the Central Bank of Sudan's Higher Shari'ah Supervisory Board (HSSB), that the system be implemented based on the Takāful (joint guarantee or solidarity) concept, where the participants in the deposit protection include Islamic financial institutions, investment account holders, the ministry of finance, and the central bank. The participants commit to make contributions to enable mutual protection and do

5- Ian McCarthy, (1980). "Deposit Insurance: Theory and Practice", IMF Staff Papers, vol. 27, no.3, September 1980, International Monetary Fund, Washington D.C, (P.596).
6- Maria L Fres-Felix, (1991). deposit insurance schemes: its nature, roles and issues, the South East Asian Central Banks (SEACEN) Research and Training Centre, Kuala Lumpur, Malaysia, (p.59).
7- http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/07_shariah_resolution.pdf
8- Osman Babakar Ahmed, (1428). nizam Himayat al-wadai Ñ lada al-masarif al-Ilamiyah, MaÑhad al-Islami li al-Baíth wa al-tadrib, 2nd ed,

not expect any financial compensation.[9]

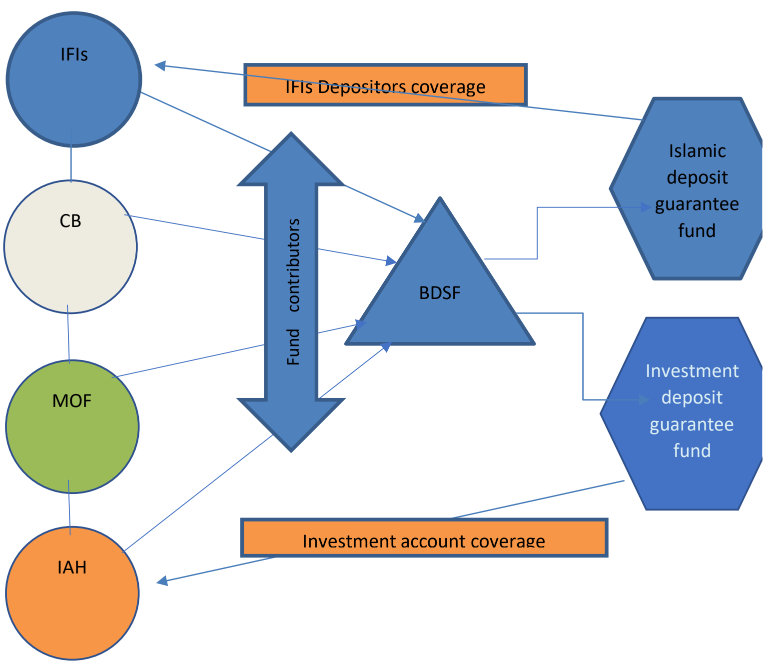
Banking Deposit Insurance Law 1996 of Sudan requires among other things, to establish special fund that will be a separate and independent entity. Secondly, the fund will have the following objectives:

a. to protect the rights of the depositors and safety of the guaranteed banks and to strengthen the confidence in them.
b. to ensure the deposit in the guaranteed banks are in accordance with the law,
c. to relief the crisis when it occurs in collaboration with the monitoring authority, the banks, and the depositors themselves.

The law has divided the insurance into several portfolios and departments within the framework of the fund. i) cooperative portfolio to protect the current and saving account and its source of fund to be from commercial banks, finance ministry, and Sudan's Central bank. ii) cooperative portfolio to protect the investment deposits and the contribution to be from owners of the investment deposits; iii) cooperative portfolio for relief situation such as severe financial distress, where the money for this portfolio will come from banks, finance ministry, and the central bank of Sudan

This fund is managed by the government through the central bank and the members of the fund include representatives from the central bank, finance ministry, and union of Sudanese banks. The law requires the fund to play its role to help the distressed banks i.e., compensate. It also requires playing preventive role consisting of monitoring the conditions of the banks, and to conduct studies of their performance and get sufficient information about those banks from the central Bank. The fund has the power to ask the central bank to conduct special review for any bank or to search accounts and books of the banks if needed. The law does not detail the maximum limit which can be compensated. The management will decide the limit of the compensation in cooperation with the central bank and the maximum limit should be reviewed periodically to cover the biggest number of depositors .[10]

Sudan Takaful-based deposit protection model structure:



BDSF - Bank Deposit Security Fund
IFI - Islamic financial institution
CB - Central Bank
MOF - Ministry of Finance

In Jordan, the Islamic Bank of Jordan (IBJ) is considered one of the pioneers in deposit protection scheme. It is the only Islamic bank where its management has given attention to Mudarabah deposit protection, to the extent of putting it in its articles of association to make it binding on the executive management of the bank. The Fatwa Council of Islamic Studies and Research has issued the requisite Fatwa for establishing the deposit protection scheme based on the Shari'ah principles of Takāful. The Islamic Deposit Protection is a legal entity that will be segregated and administered separately

and independently from the existing deposit protection scheme, thus preventing any co-mingling of conventional and Islamic deposit protection funds[11]. The fund is managed by Jordan's deposit insurance corporation under the Wakālah bi al-ajr (agency with fee) arrangement.[12]

In Bahrain, the deposit protection

9- Syed Faiq Najeeb & Madaa Munjid Mustafa, (2016). The Role and Mechanisms of Shari'a Complaint Deposit Insurance Scheme, IFSB, (P. 33).
10- Osman Babakar Ahmed, (2007). Nidamu Himayat al-wadai' lada al-Masarif al-Islamiyah, IDB, 2d Ed., (p.52).
11- Ibid.
12- Ibid.

for Islamic banks was introduced by the Central Bank of Bahrain (CBB) in 2012 to promulgating a Regulation Protecting Deposits and Unrestricted Investment Accounts pursuant to Article 177 of Central Bank and Financial Institutions Law No. (64) of 2006. The regulation provides in Article 2 the establishment by the CBB a board named the "Deposit and Unrestricted Investment Accounts Protection Board" which is responsible for the protection of eligible accounts in accordance with the provisions of this regulation, including determining:

a. what contributions banks should make to the Conventional Fund and Islamic Fund respectively?

b. the amounts of compensation to be paid out to eligible depositors and / or investors in accordance with this regulation; and

c. any additional rules under which the board will operate[13].

The creation of the deposit protection fund under the above regulation was approved by the Shari'ah Supervisory Board (SSB) of the CBB. This regulation, however, makes the claims made by the Islamic banks' Unrestricted Investment Accounts holders subject to the approval of the SSB of respective banks. The maximum amount that an eligible account could receive under the regulation is BD20,000 (US$53,200)[14]. In the event of the amounts of the relevant fund being insufficient to cover the total compensation payable in accordance with this regulation, the board may cover the shortfall by borrowing or arranging Shari'ah-compliant financing in case of the Islamic fund and such borrowings and financing facilities shall be reimbursed by future contributions from the Islamic banks as the case maybe[15].

The regulation requires that the board, which is administering the funds, would setup two separate funds for Conventional Banks and the Islamic Banks. This is required under Article 13 of the regulation which also states that each Fund shall constitute a separate legal entity and shall have an independent balance sheet from the CBB. The contribution of each Islamic bank in the total amount of the fund shall be determined on an annual pro-rata basis of the total eligible accounts of all Islamic banks in the kingdom.

In Türkiye, in the event any institution authorized to collect deposit and participation funds are not able to meet the obligation towards depositors the government or a fund established for this purpose will be the guarantor of partial or full payment by the institution of the customers' deposits. The institution designated to protect deposits and participation funds is the Savings Deposit Insurance Fund (TMSF / Fund), which was established in 1983 and it is a public legal entity[16]. All legally licensed banks whether foreign or local institutions are members of the deposit insurance system. There is no distinction between conventional and participation (Islamic) banks regarding the membership of the insurance system. In its current form the board increased the coverage limit to TRY200,000 (US$10,700) starting from the beginning of the 2022 calendar year[17].

There are many other Muslim jurisdictions where conventional deposit insurance scheme facility exists within their jurisdiction and is granted universally to conventional banks and Islamic banks licensed by the central bank / monetary authority[18]. The Islamic deposit protection schemes are not well developed (or do not exist) in many Muslim jurisdictions, even in some countries where Islamic banks is present. As discussed, the Islamic deposit schemes exists in few Muslim jurisdictions as separately administered entity or under the regulatory authority management. If those models succeed in fulfilling their objectives, they could be good examples to emulate for other jurisdictions that have not established the Islamic deposit protection schemes.

7. Central banks and deposit protection

The central banks regulate both the conventional as well as the Islamic banks in countries where Islamic banks operates. The central banks have measures in place to minimize the risk of the bank deposits. These measures are referred to as general measures, including statutory reserve requirement (SLR), imposed by monetary authority or central banks on all banks which are under their supervision[19].

13- https://cbben.thomsonreuters.com/sites/default/files/net_file_store/CBB_resolution34_eng_ver2.pdf.
14- https://cbben.thomsonreuters.com/sites/default/files/net_file_store/CBB_resolution34_eng_ver2.pdf.
15- Article 19 of Regulation No. (34) of 2010 Protecting Deposits and Unrestricted Investment Accounts.
16- https://www.tmsf.org.tr/tr/Tmsf/Mevduat/mevduat.hakkinda.
17- Savings Deposit Insurance Fund, 2021 ANNUAL REPORT, March 2022, p. 27
18- Syed Faiq Najeeb & Madaa Munjid Mustafa, (2016). The Role and Mechanisms of Shari'a Complaint Deposit Insurance Scheme, IFSB, , (P. 27).
19- Osman Babakar Ahmed, (2007). Nidamu Himayat al-wadai' lada al-Masarif al-Islamiyah, IDB, 2d Ed.

In countries where the central banks are confident with the structural liquidity situation of the banking sector, the required percentage could be less, for example the CBB rulebook states: All retail banks operating in the Kingdom of Bahrain are required to maintain reserves deposited at the CBB amounting to 5% of the value of non-bank deposits denominated in Bahraini dinars"[20]. In most of the developing countries the percentage for SLR is around 20% of the total monthly deposit. Some central banks also require the banks to have liquid assets to face the daily withdrawals of customers. These liquid assets that can be termed as Cash Reserve Requirement (CRR) could be in the form of local and foreign currencies, which include deposits with the central bank, deposits with other local banks which can be withdrawn and the deposits with foreign banks which are withdrawable. In Malaysia, the law requires licensed banks to hold minimum or minimum average amount of liquid assets at all times over such period of time as may be set out by the authority[21]. This average is expressed as percentage of all liabilities incurred by a bank or as may be specified by the authority[22].

The central bank may also take other steps to safeguard the interest of depositors if a particular licensed bank does not meet the required standards. The steps could include suspending the activities of an institution if the central bank deems that it is necessary to take that step to protect customers› interest.

8. Stand-alone deposit insurance scheme for Islamic banks

The discussion so far was about deposit insurance scheme that covers both Islamic banks as well as the conventional banks. However, in Malaysian a statutory body takes care of both conventional and Islamic banks where there are separate accounts for the two respective funds. Some scholars have argued that there should be an independent takaful scheme for Islamic deposit under its own separate regime.

The proposed deposit protection for Islamic banks is based on the principle that the Mudarib is responsible for loss if any due to its negligence and transgression, or acting beyond the conditions and scope of the contract. It implies that deposit holders as finance providers are responsible for the normal business loss, if any. It is also suggested that any protection scheme can be based on cooperation (Takaful) between banks. Dr Osman Babakar[23] suggested that the scheme relies on the cooperative concept, where the current account deposit is guaranteed as Qard with the permission to use and providing guarantee for investment deposits under the situations mentioned above.

The nature of the proposed scheme is non-profit oriented. It is a cooperative scheme to help all Islamic banks which may face financial difficulties. It plays a role of intervening or extending money to Islamic banks when they are in[24]. The core of the scheme is cooperation between banks for one common goal, which is to help one another in mitigating the harm when the need arises.

8.1 Functions of Takaful-based deposit protection scheme

The Islamic deposit insurance scheme also plays a basic role of providing the banks with funds during financial difficulties. It may also encourage banks to increase their capital in accordance with the size of their activities. In the event of a financial crisis, as part of the assistance, the scheme will buy the affected financial assets from struggling banks to help them face the crisis and clear their books. Part of the efforts to help the crisis affected banks is to take over the non-performing financing from banks in difficulties. Besides, the scheme is expected to regulate and put in place suitable standards for joining the scheme (Osman Babakar, 2007).

8.2 Nature of protection required

The nature of protection covers two aspects. The first one is to help banks during the financial crises that requires urgent intervention by providing funds especially for a short term. The second one is protecting Islamic banks against total bankruptcy and fall out of the market due to the insufficiency of the banks' assets to cover the claims of the depositors (Osman Babakar, 2007).

Although Islamic banks have some built-in risk control mechanisms, yet they are part of the market, and can be affected by its turbulence. The good thing about Islamic banks is that they are less vulnerable to hazards of the market as it has been observed from the past economic crisis. According to Laurens Nijzink, "Islamic banks

20- The CBB Rulebook, monetary policy module.
21- Section 38 of the Banking and Financial Institutions Act 1989.
22- Ibid
23- Dr Osman Babakar is an author based in the Institute of Training and Development under Islamic Development Bank in Jeddah Saudi Arabia.
24- Osman Babakar Ahmed, (2007). Nidamu Íimayat al-wadai' lada al-Masarif al-Islamiyah, IDB, 2d Ed., p. 102

seem immune from the current credit crisis. The market should provide the practical answer to the question, whether Islamic banking could be a viable alternative to the current capitalistic system. According to Prof. Abdullah Turkistani, Director of an Islamic Economic Research Centre in Saudi Arabia, the 2008 financial crisis affected almost every financial institution, including Islamic banks. He adds, «If you want to see the negative effects to Islamic banking, it is almost negligible compared to what happened to other banks" (Osman Babakar, 2007). This is a point to show that Islamic banks too may at certain times need rescue from financial instability and that is where the deposit protection scheme takes prominence.

8.3 Management of the scheme

The institutions or parties that are responsible for management of the deposit insurance scheme is also important. Should it be run or managed by the government or independent agencies? Dr Osman mentioned three models as given below:

a. by a government agency like the central bank e.g., Sri Lanka;

b. by a government agency which is independent financially and management wise, e.g. USA and India; and

c. by private entities like union of banks. e.g., France, Italy[25] and Malaysia where there is a private corporate entity that manages the deposit insurance institution.

The Malaysian model seems to be a combination of both private and public management. The board of the Malaysian Deposit Insurance Corporation Act consists of the following directors:

a. chairman appointed by the minster who shall have relevant private sector experience;

b. Governor of Bank Negara Malaysia;

c. Secretary General of the Treasury;

d. director appointed by the minster from the public sector; and

e. not more than three other directors appointed by the minster, who shall have relevant private sector experience and at least one of whom shall have relevant banking and financial sector experience[26].

The management include both private and government officers. This could be a good approach as both the government and the private sectors are involved in providing the skill and attention needed to run the scheme which will serve the best interest of the banks at the end. This model may be investigated by other countries to be adopted.

8.4 Source of funding

For the scheme to have sufficient fund for deposit protection, Babakar (2007) suggested to come from the following sources:

a. capital contribution from Islamic banks as contribution which is payable only once;

b. periodical contribution by Islamic banks to the scheme; and

c. government contribution.

As investments in projects cannot be guaranteed by neither of the contracting parties the contribution of Islamic banks to protect the Mudarabah deposit must be based on the Tabarru'(charity) on the one hand, and Takaful on the other hand. The amount of money contributed by the banks as Tabarru' would not be returned to the contributor, and the contributor might not necessarily face financial difficulties requiring rescue from the fund. The purpose of the contribution is to minimize or cover the potential loss that may affect the bank, while it is not certain that the loss would happen. If it does not happen, can the contributor claim the contributed amount to be repaid and if so on what basis? Can it be tabaru' when it is made based on potential consideration? These are questions that need to be addressed regarding the tabaru' concept.

In Malaysia, the source of fund is purely from the premium collected from the member banks. The law requires that the corporation shall maintain and administer two separate funds: the first one is for Islamic fund which shall comprise of all premiums received by the corporation under the Act, and all other monies or assets which may in any manner become lawfully payable to or received by or vested in the corporation relating to any matter incidental to its powers, duties, and functions, in respect of Islamic deposit[27].

8.5 Investment of deposit protection fund and its use

Should the corporation managing the fund just keep it for its original purpose or is it allowed to

25- Osman Babakar Ahmed, (2007). Nidamu Íimayat al-wadai' lada al-Masarif al-Islamiyah, IDB, 2d Ed.,

26- Section 11 (2) of the Malaysian Deposit Insurance Corporation Act 2005

27- Section 29(1) of Malaysia Deposit Insurance Corporation Act 2005.

invest? And if allowed, is there any restriction on investing it? Would that investment jeopardize the purpose of the fund which is to rescue banks with immediate cash when needed? Such funds might be invested in the government securities, which are guaranteed by the government. Funds can also be invested in short term Murābahah or may be in sovereign sukuk in the absence of any other viable investment avenue(s). The Malaysian Deposit Insurance Act specifies that the MDIC may invest in the following:

a. Ringgit denominated securities issued or guaranteed by the government or Bank Negara Malaysia or of high investment grade as rated by reputable rating agency.
b. deposits of Bank Negara Malaysia or any financial institution; or
c. any other investment as approved by the ministers, upon the recommendation of the board.

The MDIC further states that any investment made by the Corporation from the Islamic fund shall be in accordance with Shari'ah principles[28].

8.6 Membership of the scheme

Just as the conventional schemes, the membership of Islamic banks to the protection scheme must be compulsory, but the risk which the scheme members undertake must be reflective of the size of the member banks of the scheme and their risk appetite so that justice is done to the weaker and small-size banks. As discussed earlier, in Malaysia, the membership of existing banks is compulsory, and for the new banks, it is automatic membership once the license is granted.

9. Conclusion and way forward

So, what should be the best model for Islamic deposit protection? This area can be further researched considering the nature of jurisdiction, size and maturity of respective markets etc. While the schemes summarized above are all important and relevant, the best models should be one that provides the maximum coverage possible, regardless of the type of deposits. The financial institutions, the central bank, the ministry of finance, and certain investment account holders should contribute to the fund for deposit protection. The fund that is covering Islamic deposits should consider the following two options:

a. to cover 100% of the current account and saving accounts; and
b. for restricted and unrestricted Mudarabah deposits, suitable protection could be given, and Sharī'ah issue overcome by adopting the Sudan and Jordan approach to provide a good alternative Islamic deposit protection model.

The deposit protection scheme is important tool to inject the confidence needed in the banking industry. However, the modus operandi of its implementation is different from one jurisdiction to another. The funds of the scheme can be invested to help it grow; the right mechanism should be in place to mitigate the potential risk exposure. There are, however, further areas of research that can bring out more refined models customised for different jurisdictions. There could also be empirical research in the areas of effectiveness of financial safety net, the advantages and disadvantages of the scheme, extent of coverage and funding of such systems, the linkage with supervision and licensing, and failed bank receivership (when appointed as a receiver for the failed banks) and resolution processes and considerations in an Islamic perspective.

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28- Ibid

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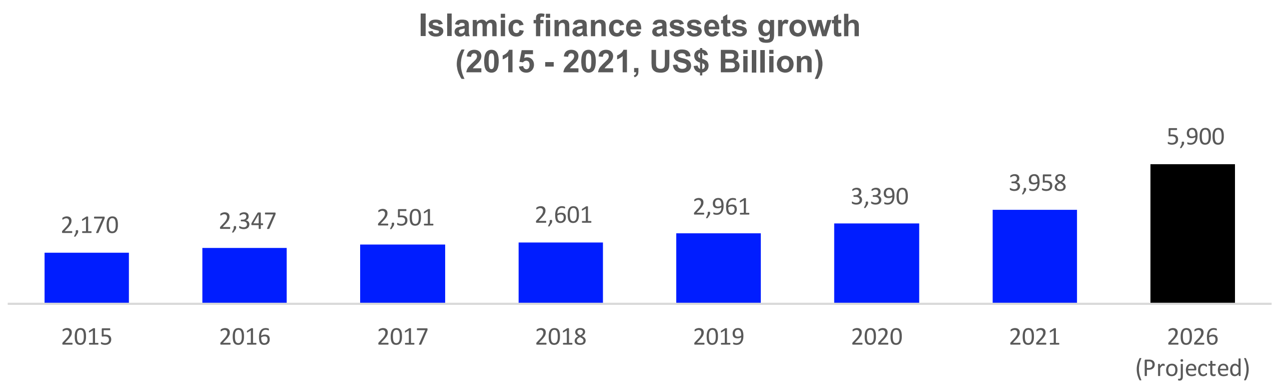
Industry update

Islamic finance industry development in 2022: Embracing change

Shereen Mohamed[1]

The Islamic finance industry reached almost US$4 trillion in 2021 on growth of 17%, up from 14% in 2020, according to the Islamic Finance Development Report 2022 . The total global net income reported by Islamic financial institutions in 2021 trebled from US$10.5 billion in 2020 to US$32.0 billion in 2021, signaling improved outcomes, especially for Islamic banks.

Following a harrowing 2020, economies started to get back on track in 2021. Regardless, the Islamic finance industry faced another challenging year with many markets cautiously getting back up to speed and countries re-opening their economies. But the onslaught of new waves of the COVID-19 virus, namely the Delta and then the Omicron variants, stalled the forward momentum. The new COVID-19 waves led to fresh lockdown or safety measures that again disrupted global supply chains and increased the cost of transport. 2021 ended on a better note as high vaccination rates prompted most countries to loosen their pandemic-related restrictions.



The top countries in Islamic finance assets are Iran, Saudi Arabia and Malaysia. Among the counties with the biggest rise in assets are Russia, Canada, the United States, Maldives, Nigeria and Tajikistan. The growth in these countries is mainly attributed to Islamic funds, sukuk and Islamic banking.

Growth across all sectors

Islamic banking, the largest sector in the Islamic finance industry holding 70% of its assets, breathed a sigh of relief as provisions for credit losses eased, pushing up net income substantially. There were three key underlying growth drivers: in some instances, banks benefited from extended government support to sectors that were pandemic-hit; a small number gained operational efficiencies from moves such as branchless banking and partnering with FinTechs; and a continued high demand for Islamic banking. Notably, the highest growth came from non-core Islamic finance jurisdictions, signalling both the growth of new markets and the plateauing of the sector in the more mature jurisdictions. Tajikistan, Burkina Faso and Ethiopia were the highlights for Islamic banking growth. Overall, the global Islamic banking sector grew by 17% to US$2.8 trillion.

Sukuk, the second largest sector by assets, grew by 14% in 2021 to US$713 billion in sukuk outstanding. New issuance rose by 9% to a record US$202.1 billion. Notably, long-term sukuk with tenors of five years or longer increased, indicating a shift in vision towards the longer horizon post-pandemic.

1- Shereen Mohamed is a Senior Research Analyst – Islamic Finance, Refinitiv, an LSEG Business

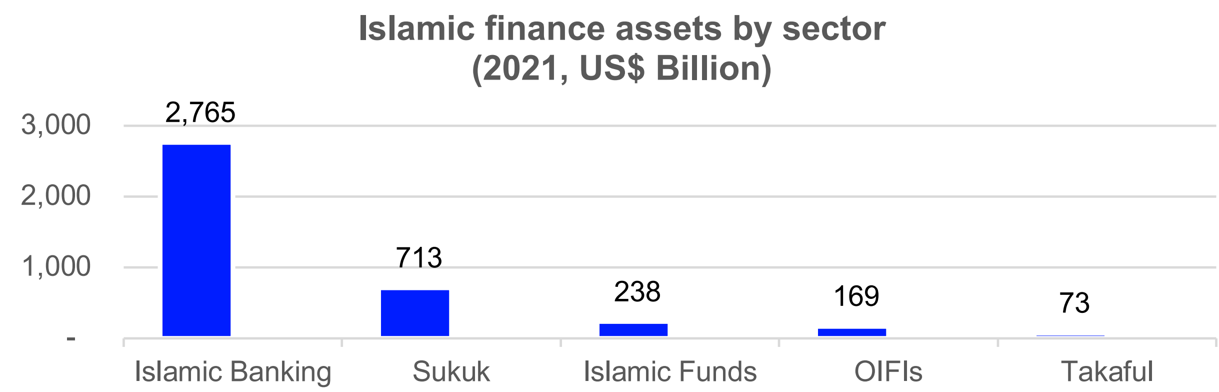
2- The report is produced annually by Refinitiv. To learn more about IFDI 2021 and download the Islamic Finance Development Report, please visit http://bit.ly/IFDI2021

Sovereigns and quasi-sovereigns continued to dominate new issuances. They also continue to dominate in the issuance of ESG sukuk that in 2021 reached a new high of US$5.3 billion. Saudi Arabia, Indonesia and Malaysia are the clear leaders in this segment that we anticipate will continue to grow with the mainstreaming of ESG investments and strong GCC demand, especially to help fund green and sustainability transition projects. Non-core markets such as Bangladesh and Egypt contributed towards this growth.

Islamic funds, the third biggest sector, saw standout growth of 34% to US$238 billion worth of assets under management in 2021. However, this sector is less widespread than banking and sukuk, with a substantial 81% of total global Islamic funds coming out of just three countries: Iran, Saudi Arabia and Malaysia. Money market and equity were the biggest asset classes but exchange traded funds (ETFs) gained traction with more appearing in different countries such as Canada, Russia and Australia. As with sukuk, ESG funds hit a notable point in the development of Islamic finance in 2021. One of the highlights was the announcement by Malaysia›s Employee Provident Fund (EPF)--that holds substantial Islamic funds--of its transition to be a sustainable investor with a fully ESG-compliant portfolio by 2030 and climate neutral portfolio by 2050. The sector is also welcoming new indices that could shape it in some countries such as Saudi Arabia and is about to see the entrance of potential new large players backed by large Islamic banks.

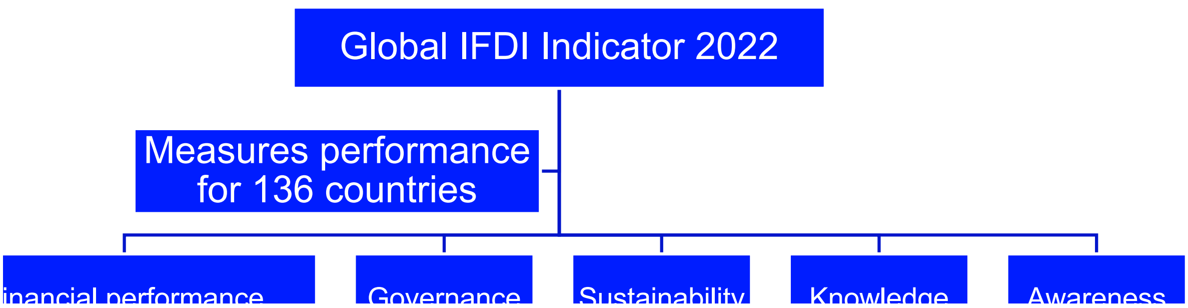
Other Islamic financial institutions (OIFIs)--including financial technology companies, investment firms, financing companies, leasing and microfinance firms, and brokers and traders--grew by 5% to US$169 billion worth of assets. Some of the fastest growth in assets were recorded in Kazakhstan, Egypt and Maldives. A headline segment in this sector is financial technology, or FinTech, that is a key focus for Saudi Arabia that plans to almost triple its number of FinTech firms from 82 to 230 by 2025.

Takaful is the smallest sector of the Islamic finance industry, holding US$73 billion in 2021 on the back of a strong 17% growth. The sector is undergoing consolidation in the Gulf Cooperation Council (GCC) countries that will streamline and reduce costs, and big regulatory changes in Southeast Asia will strengthen governance in Indonesia and Malaysia, as well as potentially welcome new entrants in the Philippines and Tajikistan.



Ecosystem growth

The growth of the asset sizes of the five sectors of Islamic finance -- namely Islamic banking, sukuk, Islamic funds, other Islamic financial institutions and takaful--contribute to the Financial Performance of the Islamic Finance Development Indicator (IFDI). As a barometer of the whole industry, the IFDI also factors in key aspects of the ecosystem: Governance, Sustainability, Knowledge and Awareness. Malaysia leads in all bar one.



The IFDI added the new metric of FinTech Sandbox to the Governance indicator this year, keeping in step with industry developments. Regulations are the backbone of Islamic finance Governance, with Islamic banking being the most widely-covered. Shariah Governance is the second strongest after Regulations as several countries have centralised Shariah boards and most have Shariah scholars who represent Islamic financial institutions. Corporate Governance is the weakest as many financial institutions returned weak reporting scores. Malaysia, Oman, Bahrain, Pakistan and Kuwait are the leaders in Governance.

On the Sustainability indicator, the IFDI considers CSR funds disbursed and ESG practices for all Islamic finance sectors and asset classes. This is one key indicator to watch as the world›s financial industry overall continues to improve on ESG practices. For the Islamic finance industry, Malaysia, Saudi Arabia, Singapore, South Africa and Jordan are the top countries.

In the overall sustainability segment, large Islamic finance markets continue to enhance guidelines or regulations. In October 2021, all eyes were on new ESG disclosure guidelines for Saudi Arabia›s stock exchange that consists of more than 200 companies.

On the Knowledge indicator, Indonesia pips Malaysia to rank first with its widespread efforts on both Education and Research. After Malaysia in second comes Saudi Arabia, Pakistan and Bahrain.

The Awareness indicator measures the number of Islamic finance Events and News. Malaysia is top-ranked, followed by Kuwait, Saudi Arabia, UAE and Bahrain.

Leading countries emerge in the enhanced IFDI model

We have made three key changes to enhance the IFDI model: the addition of new metrics related to ESG and Islamic FinTech; a re-arrangement of some of the previous metrics to form new sub-indicators; and a change of the weightage of the five main indicators by stressing more on the financial components (40% from 20%) and governance (25% from 20%).

For IFDI 2022, the core Islamic finance markets in Southeast Asia, the GCC, and South Asia lead the 136 countries we assessed. Malaysia is the leader with an IFDI score of 113, followed by Saudi Arabia (74), Indonesia (61), Bahrain (59), Kuwait (59), UAE (52), Oman (48), Pakistan (43), Qatar (38) and Bangladesh (36).

New developments

The Covid-19 lockdowns accelerated digitalisation and financial technology. The industry saw a number of digital banking moves in 2021 such as the launch of Nomo in the UK, Fardows in the United States, and Malaysia›s central bank approving two licences for Islamic digital banks.

Another notable development was in the Buy Now, Pay Later (BNPL) segment. Payments giant Visa partnered with Singapore-based Hoolah to provide a Shariah-compliant BNPL solution and Saudi-based Tamara and Tabby obtained fatwas for their BNPL.

The next step will be digital insurers and takaful operators, with Malaysia›s central bank issuing a discussion paper for their licensing framework in January 2022. Pakistan›s authorities are also working towards launching Takaful Tech, or TakTech for short.

Outlook: Large-scale growth drivers moving forward

As we write this moving into the fourth quarter of 2022, economies are hit by the continuing Russian invasion of Ukraine that is affecting energy prices and sending ripples through a large cross-section of the world›s supply chain. Inflation is also a key concern for most countries.

Looking specifically at Islamic finance, several large-scale national plans and roadmaps will give the industry a boost. These include Afghanistan, Brunei, Indonesia, Kazakhstan, Labuan, Malaysia, Oman, Pakistan and Saudi Arabia.

Key developments across North Africa where Islamic banking and takaful are gaining a lot of traction and growth, will also contribute to the expansion of Islamic finance moving forward.

The other region to look out for is Central Asia, where countries like Tajikistan, one of the fastest growing Islamic banking markets in 2021, will also kickstart its takaful sector. Kazakhstan is also fast expanding its Islamic finance industry with strong growth in Other Islamic Financial Institutions, especially FinTechs.

Overall, IFDI projects the global Islamic finance industry to grow to US$5.9 trillion by 2026 from US$4.0 trillion in 2021, mainly driven by its biggest segments Islamic banks and sukuk.

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