CONFERENCE PROCEEDINGS

THE SECOND ANNUAL CONFERENCE OF ISLAMIC ECONOMICS & ISLAMIC FINANCE

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CONFERENCE PROCEEDINGS

THE SECOND ANNUAL CONFERENCE OF ISLAMIC ECONOMICS & ISLAMIC FINANCE

London Intellectual Symposium proceedings is also included.

The Second Annual Conference of Islamic Economics & Islamic Finance was held in Toronto University: Chestnut Conference Centre on October 30th, 2014. The conference has been organized by ECO-ENA: Economics & ECO-Engineering Associate, Inc. ®, Canada

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Conference Web Page: http://www.eco-ena.ca/islamicconference2.html

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The Scientific Forum of Islamic Economics, Islamic Finance & Religious Studies @ ECO-ENA, Inc.®, Canada
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2014

The Second Annual Conference of Islamic Economics & Islamic Finance

Venue: Chestnut Conference Center; Toronto University

Toronto, ON, Canada

October 30th, 2014

Conference Chair: Dr. Ghada Gomaa A. Mohamed, ECO-ENA, Inc., Canada

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Professor Benjamin Geva, York University, *Canada*

Professor Hussein A. Hassan Al-Tamimi, University of Sharjah, *United Arab Emirates*

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The Second Annual Conference of Islamic Economics & Islamic Finance

Venue: Chestnut Conference Center; Toronto University

Toronto, Canada

October 30th, 2014.

Conference Program

8:30am – 9:00am **Reception: Coffee & Refreshments**

9:00am – Noon **1st Session**

9:00 – 9:30 Presenter: Dr. Yassir M. Samra
Title: "Is there Really a Threat of Shariah in the Financial Industry: A Comparison Between Conventional and Islamic Investment Vehicles"

9:30 – 10:00 Presenter: Professor Benjamin Geva
Title: "The monetary legal theory under the Talmud" - Jewish Economics

10:00 – 10:30 Presenter: Dr. Mahroof Athambawa
Title: "Fatwa and Its Shariah Methodology in Islamic Finance"

10:30 – 11:00 *Keynote Speaker*: Professor Rodney Wilson – via Skype
Title: "Islamic Banking Achievements and Prospects"

11:00 – 11:30 Presenter: Professor Ahmed Mamdouh – via Skype
Title: "Applying Risk Based Supervision on Insurance Companies" - An Islamic Country Case Study

11:30 – Noon Presenter: Dr. Amal Smaili
Title: "The experience in Islamic banking in a conventional system" - A country case study

Noon – 1:00pm **Mediterranean vegetable break - *All attendees invited***

1:00pm – 4:00pm **2nd Session**

1:00 – 1:30 Presenters: Ms. Nova Wulandari & Ms. Achsania Hendratmi (via Skype)
Title: "Implementation of Islamic Business Ethics on Online Commerce Activity - Business Case Study"

1:30 – 2:00 Presenter: Professor Akbar Manoussi
Title: "Financial Institutions and Islamic Orientation"

2:00 – 2:30 Presenter: Ms. Sheila Nu Nu Htay
Title: "Potential Push-Pull Factors to Introduce Takaful (Islamic Insurance) as a New Product" - A country case study

2:30 – 3:00 Presenter: Dr. Yeni Salma Barlinti
Title: "Absolute Competence of Courts on Islamic Banking Dispute Resolution" - An Islamic country case study

3:00 – 3:30 Presenter: Professor Hussein A. Hassan Al-Tamimi
Title: "Financial Risk and Islamic Banks" - A Country Case Study

3:30 – 4:00 Presenter: Mr. Mohd Bahroddin Bin Badri
Title: "Charging Fee for Guarantee in the Islamic Credit Guarantee Scheme by Credit Guarantee Corporation Malaysia Berhad: An Analysis from a Shari'ah Perspective"

4:00pm – 5:00pm 3rd Session

4:00 – 4:30 Presenter: Dr. Mohamed Fairooz Abdul Khir
Title: "SARE-Based Islamic Microcredit Facility"

4:30 – 5:00 Presenter: Dr. Ghada Mohamed
Title: "Modeling Islamic Finance within a Classical Economic Framework"

5:00pm – 6:00pm Gathering for Discussion & Dessert

The Second Annual Conference of Islamic Economics & Islamic Finance

Venue: Chestnut Conference Center; Toronto University
Toronto, Canada
October 30th, 2014.

Selected Working Papers and Articles

URL of presentations of some papers are also included

Applying Risk Based Supervision on

Saudi Arabian Insurance Companies

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Professor of Risk Management & Insurance

Department of Finance

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Abstract

The main role of supervisory authorities undertaking prudential supervision is to promote the maintenance of efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. An effective supervisory authority is able to require an insurer to take timely preventive and corrective measures if the insurer fails to operate in a manner that is consistent with sound business practices or regulatory requirements.

Traditionally, authorities have performed this role by way of compliance based supervision. Under this type of supervision, insurers must comply with a set of prudential rules generally written into the law or the subordinate legislation. The role of the supervisory authority is to ensure that insurers comply with these rules. Unfortunately, under this method of supervision - compliance based supervision- many insurers have been bankrupted. That is why in recent years, supervision has been evolving and moving from a style that is compliance based to one that is risk based. This progression has also been a feature of the activities of bank supervision and pension supervision.

Risk based supervision (RBS) requires supervisors to review the manner in which insurers are identifying and controlling risks. It requires supervisors to assess system and individual firm risk and to respond with the supervisor's own processes and interventions in line with the assessment. This, in turn, allows supervisors to allocate more resources to the insurers with the greatest risk and areas within individual insurers that are high risk. RBS involves supervisors assessing four factors: inherent risk, controls, residual risk and additional support. Under a compliance based approach, supervisory activities focus on the financial situation of the supervised entities at a given point in time. RBS on the contrary is a dynamic process where the emphasis is more on understanding and anticipating the possible risks the supervised entity will be facing when executing its business plan thus going beyond its current financial

situation.

This study aims at:

1-Determining the main features of the RBS system.

2-Explaining the importance & objectives of implementing the RBS system.

3-Explaining how to implement The RBS system & what would be the challenges that face it.

4-Suggessions regarding how to prepare the insurance sector for the implementation of the RBS system.

Introduction:

Despite the multiplicity of the reasons that led to exposing the Insurance companies to the risk of bankruptcy, there is a common factor among them that is the lack of risk management in the Insurance companies properly. It is stable in the financial analysis that there is a strong correlation between capital adequacy & solvency & the level of risk to which the company is exposed ***(Chen, R., Wong, 2004, pp 481-484).***

And, of course, the more financial solvency the insurance company has, the more confidence & dealers within insurance sector of the efficiency & effectiveness of the management of the company. Therefore, of the most important factors that affect the determination of the level of financial solvency of the Insurance companies are the following ***(Mohamad Yousif, 2008, 99. 10-12):***

1-Sufficient technical reserves.

2-Asset quality & its capability to be converted to cash in a timely manner in accordance with obligations' maturity.

3-Efficient management of the company's assets & liabilities.

4-Selection of the suitable reinsurance contracts.

As a result of the importance of the above four factors, the capital adequacy seems very important for the Insurance Company continuity & efficiency in the insurance market. It is proved that there is a positive strong correlation between the capital adequacy & the financial solvency of the Insurance Company Then, the capital adequacy should be determined as a function of the risk level, i.e. should be tied to the risks to which the company is exposed such as: the market, underwriting, liquidity, management, credit risk, ... etc..

Therefore, the new trend is to link the capital adequacy to the level of risk through setting a fixed minimum capital " as it exists now" & then add to it - according to the level of risk – a prudential minimum, which is determined as a percentage of the premiums or of loss as is the situation in the European Union Countries - index-based, where the solvency margin is determined using this method.

Beside the prudential minimum, there are many developed countries in the insurance industry such as: USA, Canada, Australia, UK, Switzerland, Sweden, Japan, Finland, Singapore & the European Union using the Risk Based Capital (RBC) where the solvency margin is determined in the light of the risk of the assets, interest rate, credit & the other risks that are related to the nature of the activity practiced by Insurance Company ***(Stephen Rossiter, 2007, p. 12).***

The problem of the Search:

When the company grows and thus its premiums volume increase to reach a certain level while the nominal issued capital still the same (fixed), this capital does not represent a sufficient safety margin to protect the policyholder' rights. It should be noted that some of the insurance policies are related to certain high risk activities more than others, and therefore, when the company underwrites this high risk activities, it should take into consideration the solvency margin & the need to add new capital to face this risk.

The previous application of the traditional control & supervision methods -financial analysis & compliance based supervision- showed that they are inadequate to prevent cases of failure or bankruptcy of the Insurance companies and pension funds and, therefore, the current method of control & supervision in most Arab states have proven to be incapable to protect the rights of policyholders and shareholders, which requires a shift to a new system that provide such protection.

It has emerged in recent years the concept of the risk based capital (RBC), especially in banks and then in insurance, but there are many countries that started applying not only the RBC, but - and most importantly - to develop an integrated system for the control & supervision of the Insurance companies that is the Risk Based Supervision (RBS). So, RBS is more general & comprehensive model of the RBC.

Therefore, in this research, we will focus on this new system to determine its concept, objectives, requirements, procedures, the risks that are being monitored and how to achieve it. Also, we will focus on how to change the current system (compliance based supervision) to RBS ***(Adel Moneer, p. 5).***

Objective of the Research: the aim of this research is to achieve the following:

1-Identify the most important features of the RBS.

2-The importance & objectives of RBS system.

3-Explain how to apply the RBS system and the challenges that facing it.

4-Determining the most important suggestions on how to prepare the insurance sector to apply the RBS system.

The importance of the research:

1-This is the first applied research in the KSA on how to apply the RBS system to control & supervise the Insurance companies.

2-It represents a road map for the application of the RBC system.

Research Plan:

The goals of this research will be attained through the following chapters & sections:

Chapter I: The traditional & recent methods of controlling & supervising the insurance companies:

Section 1: The most important risks the insurance companies face.

Section 2: The traditional methods of controlling & supervising the Insurance companies & the most important criticisms directed to it.

Section 3: The recent methods of controlling & supervising the Insurance companies

Chapter II: The RBS as methods of controlling & supervising the Insurance companies:

Section 1: Definition, objectives & requirements of RBS as methods of controlling & supervising the Insurance companies

Section 2: The most important kinds of control that the supervisory authority has to take into consideration.

Section 3: The requirements for the application of the RBS system on the insurance companies.

Chapter III: The role of the state in the insurance sector:

Section 1: Actions taken by some States to ensure the financial solvency of the insurance companies.

Section 2: Transition to applying RBS system on the insurance companies.

Section 3: How to control the risks of the insurance companies.

Chapter IV: Findings & Recommendations.

Chapter I: The Traditional & Recent Methods of Controlling & Supervising the Insurance Companies

The insurance companies are exposed to many risks that are common in part with other companies, but the insurance companies are exposed to some different specific risks that need to a special treatment either from the management or supervision side.

Section one: The Most important risks the Insurance Companies Face

This section defines the common risks that are considered in most existing risk management systems ***(Mayank Bathwal, 2009, pp. 1-2).***

Strategic risk: *is the risk associated with the insurer's business model & business strategy*. For example, an insurer that is introducing a new line of business with which it has had no prior experience or is entering a market segment in which it previously was not represented.

In this case it may face high strategic risk because the new line of business may not be accepted by the market or the insurer may have difficulty penetrating the new segment. So, the insurer faces the possibility of losing its investment in the new business and the risk of damaging its reputation.

Governance & Management risk: is the risk to the insurer that could arise from the failure of the Board of Director & Management to govern the insurer properly, whether through lack of skills or lack of probity.

Legal risk *is the risk to the insurer resulting from the legal system in which it operates.* Insurers operate in a world that is subject to a vast array of legal requirements, not only from its own insurance legislation but also from taxation, labor, company, consumer protection & competition laws … etc. In many cases, failure to comply with the requirements of these laws carries substantial penalties.

Liquidity risk *is the risk that the insurer does not manage its cash flows adequately & is therefore unable to meet its financial obligations as & when they fall due.* If an insurer cannot meet its financial obligations, there is a risk of the supervisory authority revoking its license, a loss of business or damage to its business reputation. Also considers the risk that the insurer has to borrow funds from the market at higher rates of interest than its internally generated funds because it has not managed its cash inflows & outflows effectively.

Credit risk *is the risk of default by counterparties in which the insurer has a financial interest. Insurers have three main groups of counterparties for which credit risk is relevant.*

First Reinsurers: In paying claims, especially major claims, insurers rely on their ability to obtain timely settlement from reinsurers of their portion of the claim.

Second those institutions in which the insurer holds its financial assets. In addition to premium income, insurers generate a significant portion of their income through investing funds externally.

Default by institutions in which the insurer has invested or reinsurers may have a severe impact on the insurer's profitability and liquidity.

Thirdly, insurers that have large corporate clients may write material amounts of business on account.

Credit risk extends to those clients not honoring the payment of those premiums.

Investment risk *is the risk of loss in the value of an insurer's assets due to changes in interest rates or other factors.* It is frequently referred to as market risk. Insurers may also hold assets or have incurred liabilities that are denominated in foreign currencies & are subject to changes in value when foreign exchange rates change.

Insurance risk *is the risk that the claims payable are greater than the contribution to make these payments from premiums received.* Insurers set premiums & expenses based on their expectations which themselves are uncertain.

There are two significant unknowns being the future claims & the discount rate to calculate the present value. Insurance risk is the risk that these calculations are not correct & result in the insurer incurring a technical / underwriting loss.

Operational risk *is the risk to the insurer resulting from its own internal systems, processes & procedures* (technology, fraud or breakdown), caused by either internal or external events. If there is a failure, there can be considerable disruption to the business, loss of business and costs incurred in correcting or replacing defective systems.

Section Two: Traditional Methods of Insurance Companies' Supervision

There are many methods that are used to control & supervise the Insurance companies. The most important & popular methods are:

1-Financial Ratios: Financial ratios method is one of the oldest methods of financial analysis (beginning of the 20^{th} century).

The financial ratio is a relative magnitude of two selected numerical values taken from an enterprise's financial statements. There are many standard ratios used to try to evaluate the overall financial condition of a corporation.

Financial ratios may be used by managers within a firm, by current & potential shareholders (owners) & by a firm's creditors. Financial analysts use financial ratios to compare the strengths and weaknesses in various companies.

Financial ratios are calculated & compared with the standard ones to measure the deviations between the actual & the expected values & the main reasons behind this. In spite of its importance, it is difficult to explain its positive or negative changes without knowing its components.

2-Insurance Regulatory Information System (IRIS): It is a financial analysis method established by the National Association of Insurance Commissioners (NAIC) in USA to detect problems of property & casualty insurance & life & health Insurance companies according to these audit ratios.

According to IRIS it splits the financial ratios to four categories: activity, profitability, liquidity

& reserves determination. Then, it analysis the financial statements & calculating 11 ratios for property & liability insurance & 12 ratios for life & health insurance & comparing them to a predetermined standard values calculated from the market & if they lie outside the range, then it represents an early warning for insolvency.

Even though IRIS plays an important role in ranking the companies according to their exposure to financial problems & consequently their need to be financially checked, it has some weakness such as: it needs many tests, it does not rank the companies according to their solvency margin, & it is a typical or routine model that gives a reverse results in some cases. So, we have to search for another flexible & accurate model that rank & predict the company's solvency.

3-Solvency Margin: According this method, it determine a financial solvency margin that each company should maintains as the higher of what stated in the law or a specific percentage of the earned premiums or the net incurred loss ***(Linder, U. Ronkainen, 2004, pp. 426-474).***

And, of course, when the Insurance Company' activities grow, & consequently its premiums to reach a specific limit & its issued nominal capital stay unchanged, it does not represent a safety margin to protect its policyholders, & it has to add more capital.

The main criticism to this method is that it does not take into consideration the individual differences between the risks that each company is exposed to. So, it is not suitable for most of the companies as each one is exposed to a different risks, has different experience, management, reserves, investments, etc.

Section Three: Modern Methods of Insurance Companies' Supervision

As we stated in the introduction of the research that it is stable in the science of finance & financial analysis that there is a strong correlation between capital adequacy & solvency & the level of risk to which the company is exposed.

Of course, the more financial solvency the insurance company has, it will be reflected in its activity growth, return & revenue, & consequently increases customer confidence & dealers within insurance sector of the efficiency & effectiveness of the management of the company. Therefore, of the most important factors that affect the determination of the level of financial solvency of the insurance companies are the following ***(Mohamad Yousif, 2008, pp. 10-12)***:

1-Sufficient technical reserves.

2-Asset quality & its capability to be converted to cash in a timely manner in accordance with obligations' maturity.

3-Efficient management of the company's assets & liabilities.

4-Selection of the suitable reinsurance contracts.

As a result of the importance of the above four factors that affect the insurance companies solvency level, the capital adequacy seems very important for its continuity & efficiency in the insurance market. As a result, it is supposed & a must to set a minimum capital for the Insurance companies (100 million SR in Saudi Arabia, 60 million EP in Egypt, 5 million KWD in Kuwait, 50 million USD, ***(Adel Moneer, 2007, p. 4)***), & this minimum capital should be different in life insurance & property insurance & should be scaled according to the activity level of the company.

Because of the criticism towards the traditional methods in determining the solvency margin, the National Association of insurance Commissioners (NAIC) has developed an early warning system through two systems ***(Faheem Salih Lawindi, 2000, pp. 27-28)***:

1-Financial Analysis Tracking System (FATS): Even though this system has avoided many of the disadvantages of the IRIS, but the details & how to calculate its 25 financial ratios is unknown. These obstacles restrict the ability of the Insurance companies to prepare the needed data in advance so as to pass the process of the solvency test.

2-Risk Based Capital (RBC): According to this system, the supervisory authority instead of setting the minimum required capital for licensing the insurance company, it determines it's customary so as to be sufficient enough to meet all the risks that face the company.

This system is a comprehensive one than the fixed capital & gives an accurate picture about the solvency of the Insurance Company & its exposure to insolvency. Also, it gives the authority the right to interfere through many control level to support the solvency margin (warning, capital increase, prohibiting underwriting for specific period, license withdrawal, etc…), ***(Pitselis, G., 2006, pp 11-18)***. But, the main challenges to the RBC system are its need to a large volume of data, a distinguished actuarial expertise, an advanced computer & managerial systems where there is a lack of all them in most of the Arab countries.

Chapter Two: RBS as a System for Insurance Companies' Supervision

RBS as a system for Insurance companies' supervision is a new one that has its definition, objectives & requirements to be applied.

Section One: Definition, objectives & Requirements of RBS

The main role of supervisory authorities is to promote the maintenance of efficient, fair, safe &

stable Insurance markets for the benefit & protection of policyholders. An effective supervisory authority is able to require an insurer to take timely preventive & corrective measures if it fails to operate in a manner that is consistent with sound business practices or regulatory requirements ***(AIAS Insurance Core Princples, 2004, pp. 22-23)***.

Traditionally, authorities have performed this role by way of compliance based supervision under which insurers must comply with a set of prudential rules generally written into the law or the subordinate legislation. The role of the supervisory authority is to ensure that insurers do, in fact, comply with these rules. In recent years, supervision has been evolving & moving from a compliance based to the risk based. This progression has also been a feature of the activities of bank supervision & pension supervision ***(Ton Randle, pp. 1-3).***

What is risk based supervision: risk based supervision (RBS) requires supervisors to review the manner in which insurers are identifying & controlling risks. It requires supervisors to assess system & individual firm risk & to respond with the supervisor's own processes & interventions in line with the assessment. This, in turn, allows supervisors to allocate resources to the insurers with the greatest risk & areas within individual insurers that are high risk.

The Main Objectives of Risk Based Supervision: risk based supervision is trying to achieve the following objectives ***(Yom Iyun, 2005, pp. 3-4)***:

1-Determining the timing of interfention of the supervisory authority in the insurance company.

2-Reducing the cost of insolvency throught the early intervention of the supervisory authority.

3-To be an easy system to be applied to all insurance companies.

4-To be a comprehensive system that takes into consideration that each company is exposed to risks at different levels.

And based on the evaluation of the supervisory authority, it may ask the insurance company to allocate additional resources if it is exposed to the risk more than others, where determining whether it is exposed to the risk more than others and the size of the needed additional resources depend on evaluating the following four items:

1-Inherent risk is the risk of an adverse event occurring. The inherent risk may not be the same for identical activities undertaken in different circumstances. Insurers face a large number of risks that are of concern to the supervisor and which will be explored further on.

2-Controls are those actions that are put in place to lessen the probability, the severity or both of inherent risk.

3-***Residual risk*** is the risk of an adverse event occurring even though the controls are in place & are working or being applied correctly.

4-Additional support refers to any additional factor that may be in place to deal with the outcome of an event occurring & which would lessen its overall impact.

The main characteristics of RBS: under a compliance based approach, supervisory activities focus on the financial situation of the supervised entities at a given point of time. On the contrary, RBS is a dynamic process where the emphasis is more on understanding & anticipating the possible risks the supervised entity will be facing when executing its business plan thus going beyond its current financial situation.In a sense, RBS can be said to be more preventative.

There is a greater degree of flexibility generally in RBS. Compliance relies on rules which the insurer must observe, while under RBS the authority is more focused on principles. If the rules are contained in legislation or subordinate legislation it may be costly & time consuming to change those rules in response to changes in the market. An interesting example arises from the purchase by some institutions of highly rated; yet high yielding complex financial products-one of the events that led to the 2008 global financial crisis.

A RBS approach is more likely to have identified the apparent anomaly between the high credit rating & the high rate of return & required the insurer to demonstrate that its capital was adequate to be able to hold these instruments. The supervisor's approach would have been based on questioning why other instruments with which it was familiar & which had similar yields carried a lower credit rating. This analysis would have substituted for reliance on the ratings assigned externally to instruments which the market in retrospect did not understand.

The Main Benefits of Applying RBS System: The applying of RBS will avheive the following benefits:

1-Economic utilizing of the resources through concentrating on risks.

2-Best estimate for risks through separate evaluation of company's inherit risks & risk management functions.

3-Let supervisory authority to concentrate on the insurance companies that face higher risks.

4-Notifying the insurance companies with the evaluation of their risks.

5-Early warning system of insurers' risk.

How is RBS conducted? Supervisors perform RBS by looking at all the material risks that are faced by an insurer & how it controls those risks. Supervisors assess the financial position of the insurer in the context of the residual risk & its ability to raise further capital if it is required to do so. In conducting reviews, the policies, process & systems of the insurer & the compliance with these are critical. A low risk insurer is one which has excellent policies and systems to mitigate risks & implements them effectively at all times & is well capitalized with access to additional capital if required. The inputs into the assessment come from onsite & offsite reviews & the available information about the market

(Michael Hafeman & Tony Randle, 2009, pp. 3-4).

Section 2: The Most Important Kinds of Control that the Supervisory Authority has to take into Consideration.

Before discussing the controls for the individual risks in the previous section, it is helpful to consider the role of the different participants in the risk management process ***(Narjess Boukaki, 2011, pp501-518).***

The role of the Board *is to determine the risk preference for the insurer, set its overall direction and to ensure that management is following the direction that it has set.*

The role of the Management *is to implement the strategies & overall direction of the Board. Management makes decisions on how these strategies and direction are to be achieved, sets policies & procedures to ensure they are communicated to operational staff. Management also monitors compliance with the policies and procedures.*

The role of the External Auditor *is to ensure that the insurer presents a true and fair view of its operations to stakeholders and to express a view on the insurer's adherence to its policies and procedures.*

The Internal Auditor *is responsible to the Board for ensuring that the management is implementing the strategies and directions of the Board & that operational staff is complying with the policies & procedures that have been formulated by the management. In some insurers, the Internal Auditor is also the Risk Manager, whose responsibility is to identify risks & ensure that adequate risk management systems are in place to mitigate these risks to the level of the Board's risk appetite.*

The role of the Actuary *is to advise on the financial soundness of the insurer and ensure especially that insurance risk is properly estimated and mitigated.* All these roles are essential to effective risk management & an assessment of how the insurer is controlling risks could not be completed without an assessment of how the roles are being fulfilled.

What is meant by "additional support" for insurers? To date, the discussion has focused on the measurement of residual risk. Even an insurer with a high degree of residual risk may not necessarily face a high risk of failure if it has the capacity to absorb the losses arising from the residual risk events that occur.

This section looks at the capacity of the insurer to absorb these losses from its own resources both current and future. Although most insurance legislation contains requirements for the insurer to hold capital against unexpected losses, the manner in which this requirement is met differs quite significantly. Some legislation requires a fixed amount, some laws require a risk weighted percentage of the assets on the insurer's balance sheet and more sophisticated legislation requires insurers to hold sufficient capital commensurate with the risks of the business, subject to some minimum. For the sake of the discussion, the legal requirement is referred to as the *minimum capital requirement (MCR).*

Under an RBS approach, the supervisor concentrates on four aspects:

1-the additional capital over the MCR,

2-the quality of capital,

3-the insurer's ability to raise additional capital and,

4-the rate of return on the additional capital.

Obviously, the greater the excess of capital over the insurer's MCR, the greater is its ability to deal with unexpected losses. However, not all capital instruments are equal & this fact requires the supervisor to consider the quality of each item that an insurer regards as capital.

The common example is subordinated debt which is quasi capital, ranks ahead of common stock and is generally accepted as being a capital instrument of inferior quality compared with common stock. Not all regulatory regimes consider such quasi capital in their system at all. An important factor in the discussion about capital is the ability of insurers to raise additional capital should the need arise. Assessment of the insurers' ability requires supervisors to ***(Stewart Economics, Inc., 2007, pp. 23-27):***

1-understand how the insurer manages its capital,

2-what contingency plans it has in place to raise additional capital if needed &,

3-the willingness and ability of shareholders to subscribe further amounts, particularly major shareholders.

This is particularly important where the insurer is part of a financial group if it relies on other entities within the group for capital support. Finally, supervisors using RBS will have to consider earnings for two reasons:

1-it can be used to absorb losses &,

2-It can be used to reestablish reserves diminished by unexpected losses.

As we know, financial markets generally do not like corporations that exhibit widely inconsistent earnings between reporting periods. So the market view may have some bearing on the ability of an insurer to raise additional capital. The supervisor under the RBS approach looks at the current earnings & future projections & forms a view as to whether the current earnings are purely from operations & whether the projections are realistic based on past trends & business plans for the future ***(Chen Wenhui, 2011, p. 1).***

Section 3: The Requirements for the Application of the RBS System on the Insurance Companies.

In order to implement RBS effectively, supervisory agencies have some preconditions that must be met. There are five elements that need to be considered: The state of the law, the structure of the supervisory agency, guidance & training for supervisors, a risk rating model & a measurement tool. Each of these will be examined in turn.

The State of the Law: the main role of the supervisor in RBS is to ascertain that insurers have sufficient capital to face their risks. If a supervisor is not satisfied that the level of capital is commensurate with the risks of an insurer, it must force the insurer to increase its capital. Tthe supervisory authority must have the power under the law to do that. Also, the authority has to have a graduated range of powers to intervene so that the interventions can be consistent with the risk assessment. If the supervisor has limited powers, it may not take the right action.

The Structure of the Supervisory Authority: as we know, the assessments of risks & the quality of controls are both subjective, so the decision of the supervisor is influenced by the attitude of individuals to personal risk. This means that, the risk averse supervisors are likely to assess risks more harshly than less risk averse supervisors to mitigate their own risk. Also, they are most probably underestimating the quality of controls.

There are many advantages of RBS but the main two of them are the ability to compare insurers and showing how an insurer's risk profile is changing over time. Then, supervisory authorities need to be structured in such a way as to ensure a high level of consistency in order to exploit these advantages. A structure that proven to be successful in many authorities is to assign the responsibility for the supervision of individual insurers to individual supervisors under the management of a person who oversees all the insurers & signs off on each risk & control assessment.

Training and guidance for supervisors: supervisory authorities will need to pay more attention to initial and ongoing training and the provision of detailed guidance to supervisors so as to deal with the possibility of inconsistency. A useful form of guidance is a series of summaries for supervisors of some attributes of an insurer that has, for example very high, high, medium, low or very low risk in relation to each risk category. The guidance needs to extend to the attributes for each part of the control environment. This guidance needs to be done to supervisors through formal training sessions. Because supervisors will be making a transition from objective rules based compliance assessments to more subjective risk assessments; so ongoing and follow up training is essential.

Risk rating model: when we assess the risk, all its outcomes should be summarized in a risk model. This model would summarize each of the risk and control factors measured and produce an overall risk assessment. The advancement of the model depends on how the supervisory agency choses to express the assessments. A very simple risk models would express the assessment result in qualitative measures (very high, high, medium and highly likely, likely, etc,). But the more advanced models would express the assessment result in qualitative and quantitative measures. The risk model should be in a way that helps in comparing insurers and differentiating between them.

Also, the risk assessement modle should assign weights to risks so as to reflect the the significance of individual risks that may vary between insurers (i.e., an insurer that cedes more premiums to a reinsurer may have more credit risk & less underwriting risk than an insurer that cedes less). Also, we have to rely on & take into consideration the evaluation of the rating agencies, as they beside RBS both of them form a view of an insurer's risk where external ratings would add a validation to an authority's risk model.

If the model is has been selected & constructed correctly, it would be easy to have a correlation between the supervisor's risk assessment and the agency's external rating, for example, an external agency may assigns an AAA rating to an insurer while the supervisor considers it to be low risk, or vice versa). Finaly, eventhough the credit ratings of external agencies would help in checking the calibrations of an authority's risk model, they should not be used as a substitute for it.

Measurement tool: supervisors should analyze and comment formally on each risk identified and the quality of each of risk management tools. But, under RBS, besides the above, a supervisor has to perform an indepth analysis. The supervisors are expected to justify the ratings they have been assigned to each risk & control. That's why the authorities must design templates so as to increase the consistency between ratings when using them with comprehensive guidance materials.

Chapter III: The Role of the State in the Insurance Sector:

It is interesting to note that in developed countries, minimum capital requirements are becoming more risk based. This is, in some part, because an RBS approach that measures the adequacy of capital requires a measure that is more consistent with the risk profile of the insurer.

The Boards of insurers in the countries that will adopt the Solvency II capital requirements will be required to hold minimum capital that is commensurate with the insurer's risk & to manage the capital and risk relationship. Supervisors in these countries will have an obligation to set individual MCRs with regard to the risk characteristics of each insurer. This approach mirrors the requirements for banks under the Basel II capital accord. For supervisory authorities in countries adopting Solvency II, RBS is imminent.

The insurers in Solvency II compliant countries will have to put in some formal measures for assessing risk. The insurer's assessment will provide a valuable input into the supervisor's assessment & negotiations with the insurer on its minimum capital requirement. Supervisory agencies in countries that will not adopt Solvency II should nevertheless encourage insurers to formalize their risk assessment & management.

In this chapter we will explaine how to manage the insurance companies' risks & determining the role & responsibilities of each part in this matter.

Section 1: Actions Taken by Some States to Ensure the Financial Solvency of the Insurance Companies

Role of Government in Insurance: government has three main roles in insurance. *The first* one is to ensure that those who are granted licenses are competent to enter the business and will have sufficient scale. *The second* is to ensure that there are sufficient competitors to prevent cartels from developing, while limiting numbers to a level that prevents pyramid structures (known as cash flow underwriting) from emerging. Insurers are prone to pyramid structures because premiums are paid well in advance of claims and the ultimate cost of claims is uncertain. The main tools to achieve these potentially conflicting objectives are minimum capital requirements, licensing rules and centralized claims data collection so that indicative pure premiums can be published. Market premiums are pure premiums loaded for expenses and cost of supporting capital. *The third* role is to protect the public. This is not the same as preventing insurer insolvency ***(Rodney Lester, 2009, pp. 3-4)***.

In fact allowing an insurer in trouble to delay insolvency (known as regulatory forbearance) can be inimical to the public interest and involve substantial unexpected and unnecessary public expenditures. This recognition has contributed to the development of risk based supervisory approaches, including corrective actions and enforcement based on the ratio of actual capital to statutory measures of risk based capital.

Liberalization: there is strong pressure on transition countries to open up their local insurance sectors to international competition, even if this only means the ability to establish a local subsidiary or joint venture. This pressure comes from various sources; the most common one is WTO (GATS). A number of countries have agreed to open up their insurance sectors, sometimes as a trade off for enhanced physical goods access to developed markets or to deflect attention from the banking sector ***(Rodney Lester, 2009, pp. 13-14)***.

Critical steps required before an insurance market is opened up include strengthening the regulatory regime and raising the capacity of the supervisory entity, developing necessary local skills and standards (accounting, auditing actuarial) and privatizing, or at least corporatizing any government owned or controlled insurers. It may also be necessary to first put mandatory insurance classes such as motor third party liability onto a sound financial and operational basis.

Financial supervisor cooperation or integration: while it is tempting to apply a one size fits all approach to supervisory coordination, experience to date shows that every country is different and a degree of caution is needed before making any substantive recommendations ***(Rodney Lester, 2009, pp. 13-14)***. In smaller countries there has often been a bias towards moving all financial sector supervision under the central bank-and where this has happened results have generally been encouraging. However central banks often decline the opportunity and at this point it is better not to be specific about options.

While the need for greater coordination should naturally emerge from any reasonably thorough assessment using some or all of the IAIS ICPs the safest route is to form a joint working group to look at needs and options and to develop a detailed plan-possibly with technical support.

Accounting and information systems: insurance accounting needs to be on an accrual basis of meaningful information is to be generated. This means that the unearned portion of premiums as at the accounting date need to be reserved together with the present value of future claims obligations. This latter amount can be simply an addition of claims outstanding in claims files, with a mechanistic adjustment for claims incurred but not reported, or very complex calculations based on models in the case of long term life insurance and classes of non-life insurance where claims take a long time to stabilize and settle. Revenues need to reflect changes in unearned premiums, and claims costs changes in claims reserves and provisions. A module on insurance accrual accounting appears later in this series. Historically the reserving process has been controlled by actuaries, who tend to build in substantial safety margins. In addition assets were held at the lower of book or market, building in further safety margins.

However accounting doctrine now requires that reported profits are a good representation of reality & that surplus distribution to policyholders & owners is equitable over time. This has led to a requirement that assets are held at ‘fair’ value (that is, market for listed assets) under international accounting standards. The valuation of liabilities is also conceptually to be at ‘fair value’ but as no effective market in insurance liabilities exists the meaning of this concept remains unclear.

Section Two: Transition from Compliance Based Supervision to RBS

To convert from compliance supervision to RBS, we have to take into consideration the following ***(James E. Condolff, 2006, pp. 32-37)***:

How often should risk assessments be reviewed?

The question that comes to our mind- nuder applying the RBS- is: how ofter the evaluation of an insurer should be occurred? The short answer is every time the supervisory agency obtains information about an insurer. RBS is a dynamic process & the risk assessment should be reviewed after each onsite and offsite review. Where other information comes to the supervisor’s attention, this should trigger a review of the supervisor’s risk assessment. An example of this is where the external credit rating of a reinsurer or a large client corporation is downgraded; an RBS approach requires supervisors to review the assessment of the credit risk rating of all the insurers that are exposed to that reinsurer or corporation.

Transitioning to RBS: supervisory authorities that want to adopt a more risk-based supervisory approach need to plan the transition carefully. Although there are many advantages to the approach, there are also some risks. The main risks arise from doing the transition hastily and without proper planning. RBS requires supervisors to exercise judgments that are more subjective than they may be accustomed to doing under compliance programs. For example, under RBS, supervisors will look at the business plan of an insurer and try to estimate what effects (both positive & negative) the business plan may have on the insurer's capital.

Compliance focuses more on the quantity & quality of the insurer's present capital against prescribed requirements. It is essential that supervisors be given adequate time and training to make the transition successfully. One of the advantages of RBS is that it allows comparisons of the risk profiles of different insurers in the industry and demonstrates how the risk profiles of individual insurers evolve over time. This advantage can only be enjoyed if there is a high level of consistency in the approaches of individual supervisors and their managers to assessing risks.

Supervisory authorities need to prepare and test detailed guidance material for supervisors on what constitutes risks and controls at various levels. One of the aims of RBS is to be able to capture an insurer's risk profile. This is undertaken using a risk scoring model. Successful implementation of RBS depends on designing, testing and implementing a suitable risk scoring model.

Most supervisors that have adopted a risk based approach have introduced it gradually and in tandem with their existing compliance approaches. Only once they have become confident in the ability of their supervisors to make sound risk judgments & the reliability of their measurement tools do they become entirely risk based. This is a pertinent example of authorities trying to minimize their own risk—the risk of ineffective supervision.

Supervision & the global financial crisis: the year 2008 will be marked in history as the start of the global financial crisis that has seen failures in many financial institutions & governments having to support those financial institutions that were seen as too systemically important to fail. The debate over the causes and whether the crisis could have been avoided will continue for many years.

Some criticisms have already been leveled at supervisors for failing to ensure that institutions understood and dealt with the risks that they were undertaking and failing to ensure that institutions could raise capital from conventional sources when the need arose.

Only time will tell whether these criticisms are justified, however, the crisis does contain lessons for supervisors in the imprudence of relying on third party judgments & the need to approach supervision with experience, knowledge & importantly a healthy degree of skepticism. This is equally true whether supervision is compliance or risk based ***(Rodney Lester, 2009, p. 13)***.

An Empirical Study:

RBC is determined through two mathematical models, one for property and liability Insurance and the other for life and health Insurance through the following models ***(James E. Condolff, 2006, pp.***

32-37):

First: The RBC for Property and Liability Insurance:

$$RBC = C_0 + \sqrt{C_1^2 + C_2^2 + C_3^2 + C_4^2 + C_5^2}$$

Where: C_1 , C_2 & C_3 are the Assets risk (fixed income investment risk, other investment risk and credit risk, and: C_4 & C_5 are the Underwriting risk (underwriting reserve risk and Underwriting premium risk). C_0 is the Affiliate insurers and other off-balance sheet Risk.

After taking the covariance factor into consideration, the RBS for property and liability Insurance is determined through the following models:

$$RBC = C_0 + \sqrt{C_1^2 + C_2^2 (0.5 * C_{3a} + C_{3b})^2 + (0.5 * C_{3a} + C_4)^2 +} C_5^2$$

Where: C_{3a} is the claims towards reinsurers, and C_{3b} is the other claims.

RBC for Life and Health Insurance:

RBC is determined through the following mathematical models for life and health Insurance through the following models:

$$RBC = C_0 + C_{4a} + \sqrt{(C_{1o} + C_{3a})^2 + (C_{1cs} + C_{3c})^2 + C_2^2 + C_{3b}^2 + C_{4b}^2}$$

Where: C_2 , C_3 & C_4 are the Assets risk, Insurance risk and interest rate risk (C_{1cs} or stocks and C_{1o} for other investment).

C_{4a} is the business risk. Finally, C_{4b} is the business administration expenses.

After taking the covariance factor into consideration, the RBS for life and health Insurance is determined through the following models:

$$RBC = C_0 + \sqrt{C_1^2 + C_2^2 + (0.5 * C_{3a} + C_{3b})^2 + (0.5 * C_{3a} + C_4)^2 +} C_5^2$$

Where: C_{3a} is the claims towards reinsurers, and C_{3b} is the other claims.

Action Levels:

There are five outcomes to the RBC calculation which are determined by comparing a company's Total Adjusted Capital to its Authorized Control Level Risk-Based Capital which is called RBC Ratio, where:

RBC Ratio =	**Total Adjusted Capital (TAC)**
	Risk Based Capital (RBC)

The level of required risk-based capital is calculated & reported annually. Depending upon the level of the reported risk-based capital (RBC Ratio), a number of remedial actions, if necessary, are available as follows:

1. No action: Total Adjusted Capital of 200% or more of Authorized Control Level results in "no action."

2. Company Action Level: Total Adjusted Capital of 150 to 200% of Authorized Control Level results in Company Action Level under which the insurer must prepare a report to the regulator outlining a comprehensive financial plan that identifies the conditions that contributed to the company's financial condition. This Plan must contain proposals to correct the financial problems and provide projections of the financial condition, both with and without the proposed corrections. The Plan also must list the key assumptions underlying the projections and identify the quality of, and the problems associated with, the insurer's business. If a company fails to file this comprehensive financial plan, this failure to respond triggers the Regulatory Action Level.

3. Regulatory Action Level: Total Adjusted Capital of 100 to 150% of Authorized Control Level triggers a Regulatory Action Level. At this level, an insurance company is also required to file an action plan, & the state insurance commissioner is required to perform any examinations or analyses to the insurer's business and operations that he or she deems necessary. The state insurance commissioner also issues appropriate corrective orders to address the company's financial problems.

4. Authorized Control Level: Total Adjusted Capital 70 to 100% of the Authorized Control Level triggers an Authorized Control Level. This is the first point that the regulator to take control of the insurer. This authorization is in addition to the remedies available at the higher action levels. It is important to note that the law grants the insurance commissioner this power automatically. This action level occurs at a point where the insurer may still be technically solvent.

5. Mandatory Control Level: Total Adjusted Capital of less than 70% triggers a Mandatory Control Level that requires the regulator to take steps to place the insurer under control. This situation can occur while the insurer still has a positive level of capital and surplus; although a number of companies that trigger this action level are technically insolvent (liabilities exceed assets).

Regulator is required to liquidate or rehabilitate the company.

An Empirical Example for calculating RBC *(European Commission, Financial Institutions*

***Insurance, Oct 2001, pp. 4-8)*:**

Statement	**Statement Value**	**RBC net Factor**	**Risk -Based Capital**
Asset Risk:			
Class 1 Bonds	100,000,000	0.004	400,000
Class 1 Bonds	20,000,000	0.013	260,000
Bonds subject to size factor			**660,000**
Size Factor			1.7
Total RBC for Bonds			**1,122,000**
Common Stock	1,000,000	0.2925	292,500
Asset Concentration Factor			45,000
Total RBC for Assets - C1			**1,459,500**

Statement	Statement Value	RBC net Factor	Risk -Based Capital
<u>Insurance Risk</u>:			
Ordinary life Insurance in force	720,000,000		
Life Insurance reserves	90,000,000		
Net Amount at risk	630,000,000		
First $500 million	500,000,000	0.001495	747,500
Balance	130,000,000	0.000975	126,750
Total RBC for Insurance Risk - C2			**874,250**
<u>Interest Rate Risk:</u>			
Mathematical Reserve	90,000,000	0.007475	**672,750**
Total RBC for Interest Rate Risk – C3			**672,750**

Statement	Statement Value	RBC net Factor	Risk -Based Capital
<u>Business Risk</u>:			
Life premiums	8,000,000	0.02002	**160,160**
Total RBC for Business Risk - C-4			**160,160**
Total Risk Based Capital			
C-1			**1,459,500**
C-2			**874,250**
C-3			**672,750**
C-4			**160,160**
Total Risk Based Capital			**3,166,660**
Statement	Statement Value	RBC net Factor	**Risk -Based Capital**
Effect of Covariance			**701,982**
Company Action Level RBC			**2,464,678**
Authorized Control Level RBC (50% of Company Action Level)			**1,232,339**
Total Adjusted RBC			
Surplus	5,000,000	1	**5,000,000**
AVR	75,000	1	**75,000**
Dividend Liability	50,000	0.5	**25,000**
Total Adjusted RBC			**5,100,000**

RBC Ratio (Company's Capital)/RBC			**2.07**

In the US, the NAIC calculated the coefficient factors that are used in calculating RBC from the market data as whole (as a range), then calculating these factors for each company based on its data. So, to apply RBC for any country, we should calculate these factors from the market data as whole (as a range), then calculating these factors for each company based on its data.

Section Three: How the Supervisory Authority Control the Insurance companies Risks

In this section, we explain how the supervisory authority control the Insurance companies risks as follow:

Strategic risk: in considering how strategic risk is controlled, supervisors need to consider a number of factors including:

- Does the insurer have a formal strategic planning process & if so, does the process consider the insurer's strengths, weaknesses, opportunities & threats?
- Does the process consider the costs of the alternative strategies & the financial capacity of the insurer to pursue those strategies?
- Is the Board actively involved in the strategic planning process?
- What mechanisms are in place for the Board to monitor performance against the strategic plan & amend it if necessary?
- Is there evidence that the insurer has incurred significant write off or losses in the past due to failed business initiatives?

Governance risk: in considering how governance risk is controlled in relation to the Board, supervisors need to understand how the Board is appointed & functions & consider a number of factors including:

- Has the Board put in place a formal charter that defines its role & distinguishes it from the role of management?
- Are the individual Directors fit and proper?
- Is the Board collectively fit?
- Are there any directors who are so critical to the success of the Board that their absence would render the Board ineffective (is there any "key person" risk) & what mitigating steps are in place to address

it?

- Has the Board put in place adequate processes to deal with potential and actual conflicts of interest?
- Has the Board put in place a formal process to evaluate its own performance periodically?
- The considerations for the management are similar.

Legal risk: in considering how legal risk is controlled, supervisors need to gain a general understand of the various legal requirements to which an insurer is subject.

- Supervisors need to consider the following:
- What is in place to ensure that the Board & Management are aware of the legal framework in which the insurer operates?
- How are the legal requirements and any changes to them communicated to staff & incorporated in policies, processes & procedures?

Liquidity risk: some of the matters that supervisors need to consider in forming a view about how insurers mitigate liquidity risk are:

- Is the management of liquidity risk a concern of the Board?
- Has the insurer put in place a satisfactory set of policies & procedures to manage liquidity risk & is there evidence that the insurer is complying with these policies & procedures?
- Does the insurer prepare forecasts of its cash needs and perform stress tests or scenario tests on these forecasts?
- Is there any evidence of past liquidity problems?

Credit risk: insurers must control the credit risk that arises from their arrangements with clients (especially corporations with large premium ins.), reinsurers & institutions in which insurers invest.

Under RBS, supervisors must assess:

- Are the Board and management aware of the need to manage credit risk?
- Has the insurer installed a framework including policies and procedures to manage credit risk?
- Is compliance with the credit risk policy regularly reviewed & reported to the Board & management?

Investment risk (Market risk): again, the assessment of investment risk under RBS centers on the insurer's policies and procedures. Supervisors need to establish:

- Has the insurer installed a framework, policies & systems for managing this risk that in the supervisor's opinion are adequate?
- Has the Board established an investment committee with proper delegations from the Board to select investment opportunities?
- Has the Board established appropriate investment guidelines & are they working properly?

Insurance Risk: under an RBS framework, supervisors must target two factors: how products are designed and priced and how claims are assessed. An insurer must have in place a systematic approach under which it selects its suite of products and prices them to reflect the risk.

Supervisors need to consider the following:

- Are the Board and Management aware of the risks that are involved in the claims management process?
- Has the Board & Management put in place effective systems, policies and procedures to mitigate the risks?
- Are these in operation and working effectively?

Operational risk: operational risk arises from many components of an insurer's business and encompasses human resource management, information technology, manual processes & fraud & dishonesty to name a few functions.

Specific issues for consideration are:

- Are the Board and Management aware of ins. risk?
- Has the insurer put in place adequate policies, procedures & systems to mitigate business lines & information technology risks & what is the supervisor's assessment of the quality of these policies?
- Are these policies, procedures & systems operating effectively in practice?

Findings:

1-It appears that the solvency margin method as the most important traditional methods to insure the solvency margin does not take into account the level of risk that the Insurance companies encounter in an objective way, which makes detecting abnormal differences between Insurance companies difficult, and as result is useless in insuring the solvency margins of Insurance companies.

2-Most Arab nations in recent times headed towards raising the capital of Insurance companies in order to improve its financial performance & that in itself is a good thought however, it is insufficient as this method (constant capital for all companies) treats all companies whether big or small, deals with a few insurance products or several or whether its life insurance or general) does not take into account in its calculations risks that face companies in details & as a consequence became inappropriate as a method to insure the solvency margin for Insurance companies.

3-Arab Insurance companies also started to adjust its position to adapt with new regulations in terms of capital and types of services and credit rating and searching for partnership to support their financial position, also execute legislative repairs necessary over insurance legislations in way to keep pace with the open market environment and expected competition through reframing or modifying insurance legislatives in a way it suits with the requirements of the next phase.

4-The decisions taken from Insurance companies in managing risks affects its solvency margin and this shows importance of the control system on the risk where it gives risk management the utmost importance to the extent that the value of capital needed from each company will differ depending on the risk they underwrite in and that its exposed to and the way it is managed.

5-The reason of searching for a new system to achieve an available and sufficient solvency margin for a company which includes not facing financial difficulties comes back to the most reason for a low solvency margin which is the failure in manage the underwritten risk.

Recommendations:

1-The researcher suggests starting procedures to rectify a few legislatives relating to the relationship between the original capital level, variable capital level, solvency margin & risk limits which can allow an initial application a control system on the risk origin that faces each company.

2-The researcher recommends applying globally used accounting standards on Insurance companies especially when it comes to assessing assets such as shares with its market value until stating the financial position in a realistic sense and where the surplus distributed to the shareholders and policy holders is fair all years.

3-The researcher recommends the necessity of applying corporate governance principles over Insurance companies for the importance it brings for either shareholders, policy holders or the general public.

4-The necessity of reinforcing and supporting the connection and cooperation between Arabian Agencies Supervisory Authorities over all levels and in all areas, especially in developing organizational, supervisory and control frames as, as well as the necessary standards to organize and develop insurance work in the Arabian insurance markets and exchanging information, knowledge and joint programs.

5-Reinforcing cooperation with IAIS (International Association of Insurance Supervisors), global & local organizations that relates and is involved in the new educational program in IAIS that targets assisting insurance controllers, especially in developing countries, to improve control systems and upgrade their employees and increasing their skill sets.

6-The necessity to provide insurance institutes in all Arab countries (some countries have insurance institutes such as EFSA in Egypt, SAMA in Saudi Arabia & BIBF in Bahrain) for its major influence in raising the professional level of the insurance sector in addition to contracting allies with global institutes of insurance in advanced countries and facilitating acquiring professional designations.

7-Researcher recommends that control operations on the basis of (risk based supervision) where the supervisory agency determines and designs levels of control interference depending on level of risk relating to each company as it brings fairness & saves supervisory agencies efforts through greater attention to larger companies whose risk levels are higher.

8-Raising technical & administrative proficiency levels of workers in Insurance companies, especially underwriters, through training courses and the necessity of studying the presented risks to the companies sufficient enough to prevent it from financial difficulties and bankruptcies.

9-Generating a separate department to manage risks inside Insurance companies that operates separately in a sound risk management methodology.

10-The inspection programs must include assessing management and internal control departments & analyzing the nature of activities inside the company, its objectives and its business plan as well as assessing the systemic and administrative structure of the company.

11-Assessing marketing policies of the company's products and reviewing the regulations of commissions and production.

12-Analyzing the relationship status with the external parties and especially with the company's branches overseas, as well as the parent company and assessing the solvency margin of the Insurance Company & studying the basis of claim settlement and how to assess technical reserves and studying the adequacy of rates.

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The Experience of Islamic Banking in a Conventional System
A Country Case study: Morocco

Amal Smaili

Netherlands

Presentation URL: http://www.eco-ena.ca/f/Amal.pdf

Modeling Islamic Finance within a Classical Economic Framework

“Sukuk: Economic Benefits and International Political Risk Mathematical Theorizing - Thinking outside the Box”

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Abstract:

This paper compares between the Islamic bonds "Sukuk" and the conventional bonds within a classical theoretical framework. The paper utilizes the simple open economic version of the Solow model as a classical model to show the possibility of adopting Islamic bonds within a secular economy from one side and the economic benefit in addition to the possible political risk behind adopting such different financial instrument from the other side. This paper can be considered a different way of thinking outside the mainstream boxes. It gives an indication of the evolution of different types of economic thought that could be added to the economic literature in general.

***Keywords*:** Sukuk, Islamic bonds, Bonds, Conventional System, Classical Models, Solow Growth Model, Political Risk, Economic Benefit

JEL: A1, B, C, F, G, P, Z

Introduction

Islamic bonds "Sukuk" are considered the most important Islamic financial instruments when discussions come to Islamic finance in general. The main criterion that differentiates the Islamic bonds from the conventional bonds is that the Islamic bonds are mainly asset-based investment not just asset-backed investment. In different words they are not just about debt and loans secured by collateral but they are types of shares in the financed asset that better guarantee rigorous censorship. However, the Islamic bonds might hold political risk if they're used in the international transactions. Nowadays almost all countries trade in Islamic bonds and trillions of money is circulated in all international financial markets out of those sukuk. It's also worth mentioning that in 2009 the S&P/TSX 60 Sharia Index was already launched. On the other hand; almost all giant important international industries deal with those types of Islamic financial instruments.

In this paper I don't aim to review the literature of this domain or the conceptual comparisons between the conventional bonds and the Islamic bonds but rather I address mathematically the economic benefit and the political risk of Sukuk within a classical simple open economy model; the Solow model in its open economy version depending on the definition of the Islamic bonds used in this paper; i.e., Islamic bonds are mainly asset-based investment so both the debtor and the lender share the risk of the investment in question.

This paper is structured into three main sections after the introduction. Section II presents the mathematical framework, section III presents the optimal solution of the mathematical model, section III presents the results, the implication and the conclusion. This paper adds to the literature in this domain by adding a new way of thinking in evaluating relatively new financial instruments that might be adopted by many countries worldwide regardless of any ideological bias.

II. The Mathematical Model:

Considering a simple open economy version of the Solow model with adding features suit the target from the paper;

Assuming that firms produce a single commodity; Y by means of capital; K and labor; N; i.e., for simplicity assume that the technology is Cobb-Douglas with constant return to scale.

$$Y = K^{\alpha} N^{(1-\alpha)}, \qquad (1)$$

The number of workers equals the population size. Consider t; the time is omitted from all variables to save notations.

Domestic output can be devoted to consumption; C, investment; I, and net exports X.

$$Y = C + I + X, \qquad (2)$$

Assume that domestic residents save a certain fraction of their income;

$$S = s.\,(Y - \wp.D(I)), \qquad (3)$$

Assuming that the country in question is a debtor or a country sells Sukuk internationally to finance its domestic projects and hence its debts depend on its ambition of domestic investment. Consider $\wp$ is the share rate of the foreigner in the domestic asset in exchange for debts they lend (in different words the return rate for the foreigner). In the same time it's considered the capital cost rate for the country in question. The $\wp D(I))$ is the reward outflow.

Because lenders share the borrowers same risk and same reward; then the domestic interest rate is assumed to equal $\wp$ as well.

Consider the B is the current account deficit,

$$B = - X + \wp D(I)), \quad (4)$$

Assume that the foreign borrowings add to the foreign debt.

$$\dot{D} = B, \qquad (5)$$

Investment adds to the stock of capital; assuming zero depreciation rates to simplify the analysis.

$$\dot{K} = I, \qquad (6)$$

The representation of the model in per capita terms:

$$d(d)/dt = \dot{d} = i - s(y - \wp\, d\, f(i) - nd, \quad (7)$$

This is the fundamental equation derived from the proposal model.

Per capita current account deficit equals the difference between per capita domestic saving and per capita domestic investment. Lower letters are used here to refer to per capita variables.

$$S = s.\,(y - \wp d\, f(i)), \quad (8)$$

$$b = -X + \wp d\, f(i)), \quad (9)$$

$$\dot{d} = b - nd, \quad (10)$$

$$i = nk. \quad (11)$$

This leads to:

$$y = -(\alpha/\wp)^{((\alpha/(1-\alpha)),} \quad (12)$$

$$y = c + i + x. \quad (13)$$

Where; the per capita real GDP equals the per capita real consumption plus the per capita real investment plus the real capita real exports.

III. The steady state equilibrium & the optimal solution:

This section gives the optimal solution of the model at the steady state level.

Let $d(d)/ d(t) = zero$; thus;

$$nd = nk - s(y - \wp. D f(i)), \qquad i = nk, \quad (14)$$

To check the stability of the steady state;

Recall equation # (7) from section II the fundamental equation of the motion of the per capita foreign debt;

$$d(d) / dt = i - s(y - \wp d f(i)) - nd, \qquad (7)'$$

Which can give the following equation by taking the first differentiation with respect to the foreign debt; *d*:

$$(d(d))/ dt)/ d(d) = s. \wp. d f'(i) - n; \qquad (15)$$

And since is pinned down in the model by the per capita capital stock as it appears in equation # (11) in section (2) ; then; $f'(i)$ is zero and hence; $((d(d)/dt)/d(d)) = - n < zero$; thus; the steady state is stable; a mathematical evidence of economic growth rate convergence in the long-run.

IV. The intuitive results, implications, and conclusion:

From section III; the optimal solution confirms that the steady state equilibrium is stable and hence the growth converges in the long run as a normal result of the Solow model and its derivation within its limits and assumptions. Yet; the transition to the long run growth takes a longer time since the distance enlarges before convergence in the case of adopting the Islamic bonds instead of the conventional bonds which gives an indication of the slower growth during the transitional period from one side and a higher political risk since the lender owns with the debtor the domestic assets and their accumulations over time according to the steady state equations in section III. Figure (1) shows the result of the conventional case; view Carlberg, M. (1997) for the complete discussion of the conventional case, while; figure (2) shows the transitional analysis of the scenario of adopting the Islamic bonds – Sukuk -.

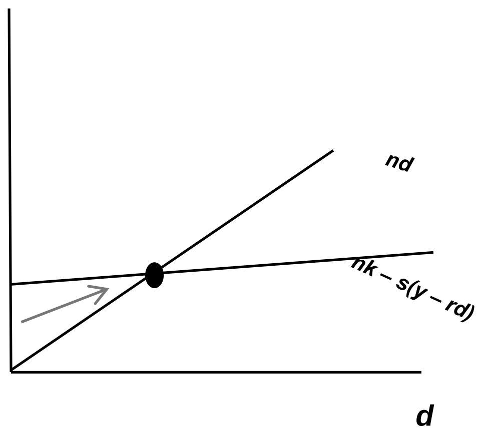

Figure 1

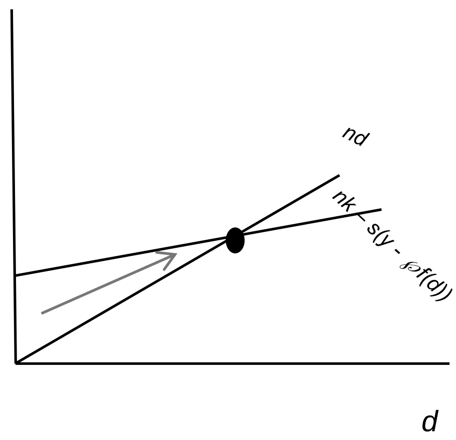

Figure 2

Mathematically speaking; equations (7)'' shows the mathematical scenario of adopting the Islamic bonds case – Figure 2 – whereas equation (16) shows the mathematical scenario of adopting the conventional bonds case – Figure 1.

$$d(d) / dt = nk - s(y - \wp d\, f(d)) - nd, \qquad (7)''$$

$$d(d) / dt = nk - s(y - rwd) - nd. \qquad (16);\ \text{Calberg (1997)}$$

It appears from both equations (7)'' and (16) that the intercept parameter of the per capita saving term is the same but the per capita saving term in equation (7)'' is steeper than the per capita saving term in equation (16) which gives the mathematical evidence of the slower growth to the long run equilibrium which can conclude that the growth of the country in question lasts for a higher period of time during the transitional period than the case of the scenario of adopting the conventional bonds which is a positive advantage for adopting the Islamic bonds but at the same time and because of the sharing percentage of the foreigner in the domestic assets then adopting the Islamic bonds holds higher political risk than adopting the conventional bonds which can be considered a negative impact of choosing the Islamic bonds for international finance.

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Fatwa and Its Shariah Methodology in Islamic Finance

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Abstract:

Fatwa plays a very significant role in Shariah by providing different resolutions and solutions to the Muslim community when it is needed to ensure the compliance with principles of Shariah and commends of God. It should be understood that fatwa is not confined to particular section in Islamic law but it covers the entire sections and subsection of Islamic law including business, finance and trade. Today, fatwa takes a different shape in Islamic finance; it is introduced and presented in the industry in the form of resolutions issued by Shariah board members who represent Shariah corporate governance body in the structure of the Islamic financial institutions. The resolution is further structured in the form of Shariah endorsement which is part and parcel of product approval as required by the regulators. The present paper discusses fatwa and its methodology in Islamic finance to ensure a sound process of issuing an accurate resolutions that comply with the rules and guidelines that have been set in Islamic jurisprudence.

GENERAL PERCEPTION OF FATWA AND ITS ROLE IN ISLAMIC FINANCE

A fatwā (Arabic: فتوى; plural fatāwā Arabic: فتاوى)

Fatwa is derived from the root fata, which includes in its semantic field the meanings "youth, newness, clarification, explanation." In the Qur'an, the term is used in two verbal forms meaning "asking for a definitive answer," and "giving a definitive answer" (4.127, 176)

In the Sharia ,It is the term for the legal opinion or learned interpretation that a qualified jurist or mufti can give on issues pertaining to the Islamic law, The person who issues a fatwā is called, in that respect, a Mufti, i.e. an issuer of fatwā, from the verb أَفْتَى 'aftā = "he gave a formal legal opinion on".

Fatwa Have a very important role in Islamic law and jurisprudence and. Nowa Days Shariah advisors are practicing as an independent body with the responsibility of issuing Shariah Rulings or fatwa to the various. Fatwa is one of the noble tasks of Prophet Hood that has been known throughout the history of mankind. Due to the critical position of fatwa competent scholars fear from it and prefer not to get involved in its process due to the implications on human life.

In the early days of Islam, fatwa were pronounced by distinguished scholars to provide guidance to the scholars, judges and citizens on how subtle points of Islamic law should be understood, interpreted or applied. There were strict rules on who is eligible to issue a valid fatwa and who could not, as well as on the conditions the fatwa must satisfy to be valid. A fatwa is not automatically part of Islamic teachings. While the person issuing it may intend to represent the teachings of Islam accurately, this does not mean that person's interpretation will gain universal acceptance.

Scope of Fatwa

Fatwa covers a wider scope, including matters of legal theory, theology, philosophy, and creeds, which are not included in fiqh studies. Thus, the concept retains a broader concern about religion and society than is reflected in the formal Islamic law defined by the five schools. From the perspective of judicial authority, realm, and enforceability, fatwa is contrasted with qadā, or court judgment. The jurisdiction of fatwa is wider than qadā matters such as ibadat (religious duties or obligations) are excluded from the power of courts, even though they are essential parts of Islamic law and appear very prominently in fiqh manuscripts and fatawa.

The major difference between the two is in their enforceability: qadā is binding and enforceable whereas fatwa is voluntary. The concept of fatwa can therefore be seen as an indirect instrument for defining formal concepts of law when applied in courts.

Islamic Schools of Law: Their Methodology of Fatwa and its Development

Several fatwa methods are applied by scholars from different schools of law, depending on various approaches in Islamic jurisprudence. We elaborate very briefly on those methods according to the popular school of law:

1. Maliki School of law:

Imam Malik was known as the “master” of the Hadith School and therefore the influence of hadith in his ijtihad is very clear, and his fatwa is tradition or hadith based. Before Imam Malik gets involved in the issuance of fatwa, he usually considers and observes a few criteria in his fatwa as follows:

• ‘Farness from fatwa’, he used to say’ I don’t know’ in most of the cases subject to his ijtihad.

• Thoughtfulness, slowness, careful consideration, deliberation before fatwa in order to provide an accurate and sound Islamic ruling. This approach demonstrates the value and appreciation given to fatwa.

• Imam Malik dislikes issuing fatwa for something which did not yet happen, i.e. Propositional law. Usually he issues the fatwa only when it happens and becomes a real case which needs an Islamic ruling.

The criteria that have been established by the Master of the school were taken into account by his followers and the leaders of the schools after him. Furthermore they have developed the methodology of the fatwa in the school and established a reliable and sound source and criteria for the fatwa in the mazhab.

The major sources of Shariah in ijtihad and fatwa observed by the Maliki School taken into consideration during the issuing of the Islamic ruling are: the Holy Quran, Hadith Sharif (tradition of the Prophet), and ijma. (consensus of legal opinion), amal ahl al madinah (tradition of people of Madina), fatawa of the companion of the prophet , qiyas(analogy), masaleh al mursalah (public interest), istihsan (juristic preference), sadu darrai (blocking the lawful means to an unlawful end), and al urf.

The above sources represent the major and important sources for ijtihad and fatwa in the Maliki School. However there are some characteristics pertaining to each source which must be fulfilled to ensure the sound approach in the interpretation of the text, or in determining the new case subject to fatwa.

2. Hanafi School of law:

Abu Hanifa, the master of this school, is one of the prominent scholars recognized by this ummah, but his methodology in fatwa and ijtihad is different from Imam Malik’s. This due to the normative influence of his intellectual environment in Iraq, where the hadith was not the back bone of his ijtihad. Instead, he depended on a rational approach and the use of intellect and reasoning as important sources for interpretation.

The major sources in the Hanafi School taken into consideration during the issuance of fatwa and Islamic ruling are: the Holy Quran, Hadith Sharif, ijma, and selection from fatawa of the companion

of the prophet, qiyas, masaleh al mursalah, al urf and Istihsan.

3. Hanbali School of law

Imam Ahmad Ibn Hanbal is the master of the Hanbali school of law and the prominent student of Imam Shafi, The Hanbali school took into consideration the following major sources when issuing the Islamic ruling and they are: the Holy Quran, sunnah (hadith sharif), ijma, fatawa of the companion of the Prophet, al ahdith al mursal (broken chain in companion) and qiyas.

Besides the above mentioned sources, Imam Ahmad considered other factors in his fatwa as follows:

- The changing of time and location (this factor is considered by other scholars as well).
- He is not restricted to his previous fatawa.
- He takes into account the principle of daroura.

• Observe the niyyah or intention of the person in his fatwa and the Islamic ruling can be affected according to his intention.

4. Imam Al Shawqani (as independent scholar)

Imam al Shawqani is not a master of any school of law but he is an independent jurist and a competent scholar accepted by the ummah. By reviewing his fatawa in finance and other aspects of Shariah we can observe some important criteria which govern his methodology in fatwa and ijtihad.

Shawqani has adopted some criteria in his fatwa methodology which can be summarized in the following points:

• Refer to al dalil (evidence) and dependence on it in issuing fatwa or in supporting any Shariah opinion.

• Independent in his ijtihad, which means that Imam Shawqani was an independent scholar in his ijtihad and interpreted the text according to his understanding as a qualified and competent scholar.

• Depending on the Arabic language in extracting the fatwa or Islamic ruling from the text.

• Connecting the branches of fiqh to the Islamic jurisprudence rules.

• Linking the investigation in fiqh with the hadith (Sunnah)

• Depending on reasoning as additional evidence to support his understanding and fatwa.

•Consideration of the social dimension in his fatwa.

• Consideration of maqasid al Shariah in his fatwa.

Fatwa in Islamic finance

Fatwa plays a crucial role in Islamic finance in regulating the market by production of Islamic rules, Shariah standards and regulations. We can observe the significant role of fatwa in the following:

• Settle unclear issues in banking and finance by issuing Islamic ruling.

• To ensure all financial transactions comply with the rules and principles of Shariah.

• To show the rules of Shariah by issuing fatwa when needed by the industry.

• To show what is lawful and what is unlawful in the financial transactions in banking and finance.

• To make sure that the requirements of Islamic law are fulfilled when new products are created

before marketing.

• Obviously the marketability of any Islamic product in Islamic banking is dependent on an approved

fatwa first before launching it in the market and introducing it to the public.

The fatwa in Islamic finance is an extension of the development of Islamic legislation throughout history. There is no doubt that the fatwa in Islamic finance represents part of the fatwa in Shariah. However in order to enhance the fatwa in Islamic finance, the scholars in this field, as represented by the Shariah advisor, should benefit from the sound methodology and accurate approach of the schools of law and the approaches of the independent scholars of the ummah at large.

Fatwa in the area of Islamic finance has become a very vital tool due to the fast growth track of the Islamic finance industry. The fatwa is said to be market driven due to the consistent demand for fatwa from the relevant parties in the industry, this necessitates the establishment of a strong fatwa methodology in Islamic finance to be adopted and implemented in issuing fatwa for various Islamic banking and finance issues, in order to ensure the soundness of the ruling.

What is greatly needed is the structuring of a standard methodology which can provide an appropriate procedure in deriving the Islamic ruling and fatwa according to Islamic jurisprudence discipline. In the structured methodology, there will be stages and technical tools that must be observed in order to issue a sound fatwa which will realise the objectives of Shariah in Islamic finance.

It is important to note here that it is not necessary for the qualified person who issues the fatwa to be an official mufti. He can be an independent jurist, a qualified and competent scholar or a Shariah advisor.

There are some rules and governance which must be observed and highlighted to the parties involved in issuing fatwa to the relevant parties in the industry, which are as follows:

• The Mufti/Shariah advisory must follow a clear, acceptable and accurate methodology in providing fatwa/ Islamic ruling, It is important that prior to that he has to fully understand the case presented to him before issuing an appropriate fatwa.,

• The Mufti/ Shariah advisory must seek easiness in his fatwa and take into account the condition of the fatwa seekers (mustafti).

• Accommodation of the easy way in issuing fatwa does not mean changing the Shariah ruling and dropping the weakest Shariah opinion and rules.

• The objective of fatwa is to moderate the problems by careful use of licenses.

• The Mufti/ Shariah advisory should be flexible in his fatwa by not being restricted to a specific School of law but rather to seek the strong Shariah opinions and the appropriate fatwa for the new case under investigation.

• If the mufti/Shariah advisory is not in a position to issue the fatwa on the spot, he can consult other scholars and Jurist in order to have a better understanding of the case.

• It is better to have a collective fatwa through joint efforts and consultations.

• The mufti/Shariah advisory should take the task of fatwa in a very serious manner and employ his best efforts while exercising ijtihad by engaging himself very actively in deliberating the Shariah issues.

• It must be understood that issuing fatwa can expose the Islamic banks and financial institutions to very serious financial obligation.

• Obviously the participation of the potential investors in a business is based on the Shariah endorsement which validates the investment from the Shariah point of view and makes the revenue halal and permissible; therefore the accountability in front of God on the investors is on the responsibility of the Shariah advisory.

Fatwa issued by Shariah board or advisory Shariah council

This type of fatwa is under a Shariah board or Shariah council; each country has a different structure and different legal framework which govern this body. The Shariah board is a legitimate control body consisting of selected members chosen based on their background in Islamic jurisprudence, Islamic law and Islamic finance. The principal duty of the Shariah board is to ensure that the current financial operations conform to Shariah rules, principles and regulations.

The Shariah advisory exercise ijtihad and issues fatwa accordingly, therefore their main task is to issue fatwa. Besides this, they are also involved in some other technical assignments and tasks within Islamic banks such as:

•Revising the structure of the financial products.

•Legal documentation and evidence regarding providers of Islamic financial services.

•Ensuring products intend to implement Shariah recommendations

•Sharing information between Shariah scholars and advisors and the institutions offering Islamic financial services.

•All Shariah Committee members are expected to participate and engage themselves actively in deliberating Shariah issues put before them.

The main duties and responsibilities of the Shariah Committee are as follows:

• To advise the Board on Shariah matters in its business operation:

The Shariah Committee shall advise the Board on Shariah matters in order to ensure that the business operations of the Islamic financial institution comply with Shariah principles at all times.

• To endorse Shariah Compliance Manuals: The Manual shall be endorsed by the Shariah Committee.

• To endorse and validate relevant documentations: the Shariah Committee must endorse the

following:

• The terms and conditions contained in the proposal form, contract, agreement or other legal documentation used in executing the transactions; and

• The product manual, marketing advertisements, sales illustrations and brochures used to describe the product.

• To assist related parties on Shariah matters for advice upon request:

The related parties of the Islamic financial institution such as its legal counsel, auditor or consultant may seek advice on Shariah matters from the Shariah Committee. The Shariah Committee is expected to provide assistance to them so that compliance with Shariah principles can be assured completely.

• To advise on matters to be referred to the SAC: The Shariah Committee must advise the Islamic financial institution to consult the SAC on any Shariah matters that have not been resolved or endorsed by the SAC.

• To provide written Shariah opinion: The Committee shall prepare written Shariah opinions in the following circumstances:

• Where the Islamic financial institution makes reference to the SAC for advice; or

• Where the Islamic financial institution submits applications to the Central bank for new product approval in accordance with guidelines on product approval issued by the Central Bank.

• To assist the SAC on reference for advice: The Shariah Committee must explain the Shariah issues involved and the recommendations for a decision. It must be supported by relevant Shariah jurisprudential literature from the established sources. The Shariah Committee is also expected to assist the SAC on any matters referred by the Islamic financial institution. Upon obtaining any advice of the SAC, the Shariah Committee shall ensure that all the SAC's decisions are properly implemented by the Islamic financial institution.

Islamic finance-The missing link

There is a need to establish an infrastructure institution for Islamic finance, something that will provide much needed transparency in the processes utilized by Shari'ah scholars to come up with Fatwas.

In the span of one decade, we have seen a number of infrastructure institutions being churned out, from prudential standard setters like the IFSB to market makers like the LMC and capital market standard setters such as the IIFM. What we have not seen come up in this decade is a central infrastructure institution to co-ordinate Islamic Finance Shari'ah scholars and their activities. While just about everyone in the industry is keen to point out the need for uniformity in Fiqh rulings, no one has even remotely provided a solution.

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ṢARF-BASED ISLAMIC MICROCREDIT FACILITY

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URL: http://journals.hbmsu.ac.ae/Pages/HTMLArticles.aspx?AID=332

IMPLEMENTATION OF ISLAMIC BUSINESS ETHICS ON ONLINE COMMERCE ACTIVITY OF DEWI HIJAB BOUTIQUE IN SURABAYA

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Presentation URL: http://www.eco-ena.ca/f/Nova_and_ACHSANIA_-_IMPLEMENTATION_OF_ISLAMIC_BUSINESS_ETHICS_.pdf

Potential Push-Pull Factors to Introduce Takaful (Islamic Insurance) as a New Product in India: Preliminary Overview

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Abstract

Nowadays, insurance becomes the backbone of our daily life since it will help us in the case of misfortune. The concept of insurance is acceptable since it is based on the noble idea. However, its practices become questionable from the religious aspect due to the involvement of interest, uncertainty and gambling. As an alternative, Takaful has been introduced and it has been widely spread in both Muslim and non-Muslim countries. In India, Takaful has not been offered yet. Due to its potential in India, the objective of this paper is to explore on the potential push-pull factors to introduce Takaful. The findings show that the pushing factor, i.e. innovative nature of the potential customers and the pulling factors such as cost vs. benefit, assessability, availability and service quality, product features, reputation of the company, attribute of agent, marketing and promotion and social and religious factors are in favor to introduce Takaful in India.

Key words: India, Insurance and Takaful.

1. Introduction

Our daily life style makes us unavoidable from engaging with the insurance. We can even assume that we are born to pay insurance. For instance, the government policy to renew the road tax requires the motor vehicle owners to buy insurance. In addition, most of the people cannot run away from insurance, especially when they are taking the financing facilities from the banks. The banks normally ask to the borrower to buy fire insurance and life insurance. Hence, the insurance plays important role in our daily activities. The concept of insurance is excellent because it provides the financial assistance for the insured in the case of misfortune. It is undeniable that the concept of insurance is acceptable from the Islamic point of view. However, the practices of insurance involve interest, uncertainty and gambling and it makes the insurance unacceptable from the Islamic aspect. This is evidenced in the First International Conference on Islamic Economics (Makkah) 1976 and Resolution of the Fiqhi Academy of OIC 1985 (Billah, 2007; Htay and Salman, 2013).

As an alternative to the insurance, Takaful has been introduced. Takaful is based on the concept of mutual contribution to help among the participants if they face any unfortunate events. In this arrangement, the Takaful operators will be coordinating this activity. Although Takaful has been formally introduced by the Muslim scholars, it is for anyone, regardless of the religion. It seems that Takaful has been widely accepted by other religions since it has been offered not only in Muslim but also non-Muslim countries (World Takaful Report, 2012).

In the case of India, it has huge number of Muslim population but to the extent of our knowledge, Takaful has not been introduced yet. It motivates us to examine what the push-pull factors to introduce Takaful in India.

2. Insurance in India

The history of insurance can be traced back to 1818 with the establishment of the Oriental Life Insurance Company and it was the first life insurance company in India. General insurance was started with the evolution of matirime trade. The first general insurance company was Triton Insurance Company Ltd. and it was established in Calcutta in 1850. Both industries have been nationalized due to the unethical practices of insurance operators. The life insurance industry was nationalized in 1956 and general insurance industry was nationalized in 1973 (Insurance Regulatory and Development Authority, 2012- 13).

Later on due to the inefficiency of nationalization, the government has set up a committee called Malhotra Committee to examine the industry. Based on the recommendation of this committee, both industries have been liberalized again although there is only one Reinsurance Company until now and it is owned by the government. Current insurance industry is governed by the Insurance Regulatory and Development Authority and the industry is at the growing stage since there are 24 life insurance companies and 27 general insurance companies (Insurance Regulatory and Development Authority, 2012- 13).

3. Takaful

Accounting, Auditing and Governance Standards for Islamic Financial Institutions (2008) defines Takaful as "a system through which the participants donate part or all of their contributions which are used to pay claims for damages suffered by some of the participants. The company's role is restricted to managing the insurance operations and investing the insurance contributions". The practice of Takaful is allowed in Islam by referring to the following Quranic verses and Hadiths.

"..Help ye one another in righteousness and piety, But help ye not one another in sin and rancor..."
(Surah Al-Maidah, 2)

"Once two women from the tribe of Huzail clashed when one of them hit the other with a stone, which killed her and also the foetus in the victim's womb. The heirs of the victim brought an action to the court of the Holy Prophet (s.a.w), who gave a verdict that the compensation for the infanticide is freeing of a male or female slave while the compensation for the killing the woman is the blood money (diyat), which to be paid by the 'Aqilah' (the paternal relatives) of the accused[1]." (Narrated by Abu Hurairah)

Similar to the conventional insurance, there are two types of Takaful, namely, general Takaful and family (life) Takaful. The coverage offered in the conventional one can be offered under Takaful as well. Only the fundamental difference between the conventional insurance and Takaful is the later one is compliant with *Shari'ah*.

4. New Product Adoption Theory and New Product Diffusion Theory

[1]Sahih Al-Bukhari, (Trans.Eng) by Khan, Dr.M.Muhsin,op.cit., Vol.9, Katab Al-Diyat, No.45, p.34.

New product adoption theory mentions the internal forces that make the potential customers to use the new products. These internal forces are related to the psychological influence, socio-cultural influences and customers' preference criteria in selecting the new products. In other words, it can be said that new product adoption theory emphasis on the pushing factors that stimulate the potential customers to buy the new products or services (Antil, 1988; Roger, 1962, 1976, 2003; Sahin, 2006).

New product diffusion theory focuses on the external forces of the customers that cause them to adopt the new products. These external factors are the pulling factors existing in the external environment and surrounding which attract or persuade the potential customers to engage with the new products. Some of the pulling factors are how the agents explain about the products, advertising, availability of the information and community (Roger, 1983; 2003).

5. Research Methodology

This paper uses the primary data through the questionnaire to know the push-pull factors in order to introduce Takaful in India. Secondary data from books, articles and internet resources are referred. Sample of 30 respondents are focused and descriptive statistics is used since this is the preliminary research. Based on the new product adoption theory, 10 questions are created to capture the pushing factors and based on the new product diffusion theory, 35 questions are prepared to represent the pulling factors attractive to the potential customers to buy new products or services.

6. Findings

6.1 Profile of Respondents

30 respondents comprise of 19 male and 11 female. Majority of the respondents have the age from 21 to 25 years and they are bachelor degree holders. In the case of religion, 12 are Muslim respondents (40%) and the rest are non-Muslims (60%). 70% of the respondents are married and the rest are single. More than half of the respondents' household incomes are more than Rs.50, 000. It is followed by 23.33% (Rs 40,001-50,000), 16.67% (Rs 10,001-20,000), 3.3% (Rs20, 001-30,000) and 3.3% (Rs30, 001-40, 000). 66.33% of the respondents have 4-6 family members or dependents, 23.33% has 7-9 members and 13.33%

has 1-3 dependents. Half of the respondents have their own houses while another half does not have. Almost one third of the respondents (30%) stay in the apartment, 23.33% of the respondents are staying in Bungalows, flats and linked houses respectively. In the case of transportation, more than half (56.67%) of the respondents have cars and followed by 40% (motor bike) and one respondent does not have his own transportation. Regarding monthly premium payment, 56.67% of the respondents pay from the range of Rs 0 to 1000, 30% pays other amount and 13.33% pays Rs 1000 to 2000.

6.2 Mean values of Respondents' Innovative Mind (Pushing Factors)

Table 1

Mean values of Respondents' Innovative Mind (Pushing Factors)

No.	Description	Mean
1	You are a risk taker.	4.17
2	You are interested to try newly developed products.	4.33
3	You like to read newspapers, magazines and explore on the internet to know new information.	4.43
4	You are not careful to try newly developed products.	4.33
5	You are not conservative (Conventional) type of person.	4.53
6	You are not reluctant to switch from the existing products to the newly developed products.	4.53
7	You do not like to follow the traditional products.	4.37
8	You have the habit of trying to use new products.	4.50
9	You are not loyal to the brand.	4.30
10	You like to discuss and get opinion from friends or others before you decide to buy.	4.43

Ten questions are asked to find out to what extend the potential customers are pushed by the innovative mind in adopting the new products. According to the new product adoption theory, the more innovative the customers, the higher possibility of adopting new product, i.e. Takaful are. To explore the innovative mind of the respondents, five point likert scale is used ranging from (1=strongly disagreed to 5= strongly agreed). Table 1 shows the mean values of the respondents' innovative mind.

The first question is related to the risk appetite of the potential customers. According to the theory, if the potential customers are risk takers, they are willing to try new things. Its mean value of 4.17 shows they are risk takers. This result is confirmed by the mean value of 4.33 (refer to question 2) reflecting that they would like to try newly developed products. In terms of their nature, the mean value of 4.43 (refer to question 3) shows that the respondents are interested to read newspapers, magazines and explore on the internet to know new information. This is the good opportunity for the potential Takaful operators to advertise in the above said media in order to introduce the new products. The mean value of 4.33 (refer to question 4) and mean value of 5.53 (refer to question 5) describe that the respondents are not conservative and there is a higher tendency that they are keen to try new products. The mean value of 4.53 (refer to question 6) and that of 4.37 (refer to question 7) show that the respondents do not like to follow the traditional products and they are not reluctant to switch to the new products. In addition, the mean value of 4.5 (refer to question 8) reveals that the respondents have the habit of using new products and they are not loyal to the brand with the mean value of 4.3 (refer to question 9). In the case of influencing factor, the mean value of 4.43 (refer to question 10) show that the customers prefer to discuss and get opinion from friends or others before they decide to buy.

All the mean values in ten questions are more than 4. According to Yasin (2004), if the mean value is more than 4, it can be rated as high. Therefore, it can be basically concluded that the respondents have highly innovative mind, i.e. the pushing factors that make them to adopt the new products or services. It is an excellent opportunity for the future Takaful operators to offer it in India in the near future.

6.3 Mean values of Determinants (Pulling Factors) to Adopt New Products

Table 2

Mean values of Determinants (Pulling Factors) to Adopt New Products

No.	Description	Mean
Part A: Cost vs. Benefit		
1	Amount of premium payment to the insurance companies.	4.07

2	The depth insurance coverage, for instance, one product comprise for health and education and etc.	4.20
3	You prefer to choose the product which has better coverage and low price.	4.47
4	Higher return from the saving and investment insurance plan.	4.37
5	In the case of surrender or early termination by the policy holders, there is no disadvantage for the policy holders, for instance, getting back the same amount of paid premium and profit.	4.20
Part B: Assessability, Availability and Service Quality		
1	Accessibility such as availability of many branches.	4.47
2	Availability of various types of products so that you have more options to choose which is the best suit to you.	4.43
3	Availability of trial with a limited cost involved will encourage you to adopt the new products.	4.23
4	Service quality, for instance, faster claim receipts and customer service	4.47
5	24 hours online service to entertain emergency such as accidents and heart attack	4.50
Part C: Product Features		
1	The products with higher observability make you interested to adopt the new products.	4.47
2	Easy to understand the product, for example, clearly written policy on the payment of premium, coverage, claim process, surrender procedure and benefits upon maturity	4.37
3	Clear illustration on the benefits of buying the products	4.40
4	Product features are flexible enough to modify based on the needs of the policy holders.	4.40
5	If you are given the option to choose among the products, you are interested to try the new products if all the features and functions of the existing and new products are the same.	4.37
Part D: Reputation of the Company		
1	Company's reputation is important, for instance, no customer complains.	4.37
2	Brand name is important in your decision making.	4.37
3	Confidence in the company, i.e. you have confidence that the company is well established and able to meet your needs specified in the policy documents.	4.57
4	Company observes ethical code of conduct.	4.40
5	Company concerns with the corporate social responsibility.	4.50
Part E: Attribute of Agents		
1	An ethical, trustworthy and responsible person	4.48

2	Understand the need of the customers and able to suggest the suitable product	4.43
3	Explain and disclose the truth regarding with the product	4.60
4	Maintain the good relationship with the customer all the times	4.43
5	Ready to help whenever necessary	4.50
Part F: Marketing and Promotion		
1	The presentation in the company broachers and pamphlets, for instance, it is clear, attractive and reliable.	4.43
2	Advertising on the website.	4.37
3	Roadshow	4.27
4	Opening the booths in the events such as conferences, education fairs, convocation and in the supermarket.	4.37
5	Advertising in cinemas, television channels and radio	4.33
Part G: Social and Religious Factors		
1	Society can influence you significantly to buy the new product, for instance, your parents, friends, office mates recommend you to buy.	4.30
2	Collective discussion among peers and opinion leaders make you to participate in the new products.	4.23
3	Requirement by the employer makes you adopt the new products.	4.40
4	Religious teaching, for instance, if the product includes the prohibited items, you are willing to find an alternative product which is acceptable in your religion.	4.37
5	Ethicality and fairness are important for me to choose among the available products.	4.20

Table 2 shows the mean values of the determinants to adopt new products. To know the determinants to adopt new products by the respondents, the total of thirty five questions are constructed. These questions are organized into 7 groups, namely, (a) cost vs. benefit, (b) assessability, availability and service quality, (c) product features, (d) reputation of the company, (e) attribute of agent, (f) marketing and promotion and (g) social and religious factors. Under each category, there are five related questions to reflect the determinants for each group.

Since human beings are rational, they will weight cost and benefit. Then, they will decide to buy when the benefit outweighs the cost. Table 2 (Part A) can be referred for the mean values of five cost-benefit pulling factors. All the mean values are more than 4 show that cost-benefit is the significant pulling factors for customers in making the economic decisions. The main determinants of pulling factors are the lower premium paid, better insurance coverage, higher return and no loss in surrender value. Thus, these findings suggest that if Takaful products are offered in India, the operators should be viable enough to compete with the existing insurance companies to ensure that Takaful products are economically attractive to the customers.

In addition to the cost and benefit, it is believed the assessability, availability and service quality of the operators are important pulling factors to the customers. Five questions are asked and their mean values can be referred to Table 2 (Part B). Since all the mean values are more than 4, it can be summed that availability of having many branches, various types of products, trial with the limited cost, excellent service quality are the main pulling factors to the customers to buy the new products.

The mean values of the product features can be referred to Table 2 (Part C). Based on the mean values of more than 4, the customers prefer to try the new products if the products are highly observable, understandable, clearly written on benefits. In addition, the future Takaful operators have good future since the potential customers are willingly to try the new products if all the features and functions of the existing and new products are the same.

Table 2 (Part D) presents the mean values of five questions which proxy the reputation of the company. Company's reputation and its brand name, ethicality, corporate social responsibility and the public confidence are the pulling factors persuading the potential customers to try the new products and services since all the mean values are more than 4.

The mean values of all the determinants are more than 4 and thus, it can be concluded that the determinants stated in the pilot test questionnaire are highly influential factors for the respondents in adopting new products.

Due to the nature of the products, most of the insurance products are sold by the agents and they are the front-liner people who represent the companies. The mean values regarding the quality of the agents can be referred to Table 2 (Part E). The pulling factors of the agents to get the new customers and to maintain the existing customers are their ethicality, ability to suggest the most suitable products to the customers, well explanation and transparent disclosure on the products, their good relationship with the customer and readiness to help the customers. Since the mean values of all the above said factors are more than 4, these factors are important determinants to attract the customers in order to adopt the new products.

Marketing and promotion is the heart of any company since it will expose itself to the potential customers and it will show how good the company is in the eyes of the public. Various types of advertising are essential since all the mean values are more than 4 (Refer to Table 2, Part F). Based on the findings, advertising in broachers and pamphlets, on the website, in the roadshow, opening the booths and in the cinemas, television channels and radio are essential to pull the customers in order to try Takaful products.

The last part of the questionnaire is related to the social and religious factors. The mean values (Refer to Table 2, Part G) shows that the main pulling factors are the influence from the surrounding society, collection discussion with peers and opinion leaders, requirement by their employers, restriction from the religious teaching and ethicality and fairness of the products.

This subsection has explained the findings of seven main categories of the pulling factors for the potential customers if Takaful is offered in India.

7. Conclusion

This paper tries to highlight the potential of introducing Takaful in India. Since it will be a new product, this paper provides the insight information to the potential Takaful operators by presenting push-full factors of the potential customers. Since the economy of the India is at the growing rate and the attitude of the customers are in favour of new products, it is important for the regulators to consider in opening the market for Takaful products. In addition, the Muslim population is added favour to the Takaful operators to get the new customers. The findings of this paper are at the preliminary stage and hence, this paper can be used as a stepping stone to explore more on the possibility of introducing Takaful in India.

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Is There Really a Threat of Shariah in the Financial Industry: A Comparison between Conventional and Islamic Investment Vehicles?

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Abstract

As the field of Islamic finance has begun to reemerge, it has largely focused on providing loans that are compliant with principles in the Islamic faith. In addition to this, a new market for Sukuk bonds has been established in Malaysia to address the concerns that many Muslims have when it comes to the preservation of capital. While some have applauded such an achievement, others have stated that these bonds, while asset-backed, are indirectly based on risk-free interest rates and therefore should be prohibited. On the other hand, in the West, there are those who are even more concerned that these Shariah-compliant investment vehicles may usurp conventional bonds. So, the purpose of this paper is to begin a dialogue that might bring both sides of this debate closer to realizing the similarities in each investment vehicle(conventional bond v. Sukuk) so that bridges of understanding may be built.

Introduction

In Islamic finance there are financial instruments utilized under the teachings of the Qu'ran. These instruments use qualities of *Shariah*, which means they all are required to exist within a moral code and laws of the Islamic religion. These instruments are being acknowledged worldwide and are beginning to be incorporated in most governments. In fact, Karasik, Wehrey, and Strom (2007) state that "Islamic Finance is slowly becoming more regulated and practiced in countries where Muslims are a majority and even in countries where Muslim minorities dominate the political and business environments (pg. 386)." One of the many instruments that are being employed is the use of Sukuk bonds, which will be addressed later.

Countries like Malaysia, Indonesia, and The United Kingdom are using Islamic finance principles as well as conventional practices to improve their economies. There is evidence that these countries have grown substantially with these two practices intertwined (Karasik, Wehrey, & Strom, 2007). As the popularity of this combining of systems continues to grow, the consistency of employing both vehicles ranges to countries where only Islamic finance exists and a hybrid coexistence where each system completes or complement each other (Karasik, Wehrey, & Strom, 2007).

Even though bridging the gap between Islamic finance and conventional finance seems ideal to the public's benefit, some Westerners are skeptical when the word *Shariah* is advocated *(*Feldman, 2008*)*. These skepticisms are generally fueled by the stigma placed on the Islamic community where one associates Islam with violence. People against the Muslim community have even begun to act in anger and assail innocent people of the Muslim faith (Yonke, 2012). Aggressive behavior, towards those who practice Islam, is continuing to rise says Hooper (2014). In fact, studies say that the anger towards the Muslim community and the law of *Shariah* are growing even though most people are ignorant of the word "*Shariah"*. The reasons behind these attacks are unknown. For example, Potok (2013) says, "it's impossible to say definitively what is driving anti-Muslim violence, 2011 saw continued and well-publicized attacks on Muslims in the form of anti-Shariah law crusades and battles over proposed mosque construction. A year earlier, in 2010, anti-Muslim crime apparently was first driven up by disputes over an Islamic center planned for lower Manhattan and the baseless claim that Islamic Shariah religious law was being imposed on the United States." This insolent behavior could be driven by the ignorance on *Shariah* Law and its benefits. As humans we tend to fear things we do not fully understand. Lovecraft (1973) writes, "The oldest and strongest emotion of mankind is fear, and the oldest and strongest kind of fear is fear of the unknown (pp 12)."

The purpose of this research paper is to make an attempt to break down this stigma as well as utilize the benefits from Islamic finance to the conventional finance world and contrariwise. We will go through what separates the two financial systems and what brings them together. Later we will see how little the differences are between Islamic finance and conventional finance. This article will in turn enervate the differences and extend knowledge to the public of both systems.

Background and Literature

Islamic Finance

"Islamic finance was first institutionalized and established in 1963 in the Egyptian town of Mit Ghamar (Karasik, Wehrey, & Strom, pg. 379, 2007)." Like many new systems that become fortifying in the future, Islamic finance has slowly grown over the years. From the start of its existence, Islamic finance started to spread to multiple countries and branch out from its origin. It evolved and expanded globally, helping diminish the gap between the poor and wealthy with no expense or overt gain to either side. Islamic finance, in a way, modernizes the way money is handled while also bringing moral behavior and social responsibility to the population.

Islamic finance was created to use compassion and commerce in a rapacity driven monetary system. It offers a more convivial approach to handling money and how it should be used. Islamic finance combines development of one's possibilities and faith to a religion or general well-being. This is why the term *riba* is prohibited in Islamic finance. *Riba* is defined as the same definition of the term, used in conventional finance, interest. Interest, is the predetermined charge placed on a new or existing loan. *Riba* (interest or usury) is prohibited because it can easily be used to take advantage of the loanee in a loaning situation and can also fuel greed. The following passage is taken directly from the Qu'ran:

> Those who eat Ribâ (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitân (Satan) leading him to insanity. That is because they say: "Trading is only like Ribâ (usury)," whereas Allâh has permitted trading and forbidden Ribâ (usury). So whosoever receives an admonition from his Lord and stops eating Ribâ (usury) shall not be punished for the past; his case is for Allâh (to judge); but whoever returns [to Ribâ (usury), such are the dwellers of the Fire - they will abide therein (Qu'ran, 2:275)

Often principles that utilize alternatives for usury are abused or altered to favor those who participate in using certain investment vehicles. For this paper, we will consider the Sukuk bonds which are presented as an alternative to conventional bonds but nonetheless pay a certain rate on the investment. Most papers on Islamic finance begin by stating that it is a compassionate alternative as it does not involve interest (El-Gamal, 2006). A very benevolent notion as the borrower may not be able to secure the cash flow required to pay off the interest payments let alone the principal amount. But upon further investigation, one notices that due to price mark-up or rent, the amount at the end of the loan is quite similar to (if not more expensive than) that of a conventional loan. Scholars have claimed that this is not a loan but rather an investment as to avoid the terms of usury or interest. This is certainly understandable as bank holding companies would essentially dissuade the retail market of Muslim investors.

Conventional Finance

Conventional finance has been in existence and started growing exponentially from the time man discovered the acts of trading goods for other goods. Over the years it has expanded geographically and is now commonly used worldwide. It was created to regulate the use of materials that are produced. Over time as companies were expanding and new companies were beginning to form, conventional finance used to help amateur business people start new businesses. These businesses needed funding in the primal stages in order to become something greater. Bonds were created so that they may be bought in order for the company to gradually flourish. When bonds are bought, the funds are used to attain materials or additional aid the company might need.

Those who bought bonds within conventional financing standards, would be reimbursed and additional money would be given. This additional money received is called interest. Depending on the interest rate (and credit worthiness), this would give bond purchasers an incentive to buy bonds of an issuing company. Bond purchasing aided those to maximize their profits in purchasing bonds while minimizing the risk towards the invested principal.

Other Investment Vehicles

There are many different kinds of investment vehicles available such as life insurance, annuities, preferred stocks, commercial paper, and common stocks to say the least. But one type of investment seems to be common in both fields and that is the investment of common stock (Ross, N/A). With common shares of a publicly held corporation, an investor seeks to earn a reward based on the market share value of the tradeable security. For a Muslim investor, there is a tight-rope to walk on as it is indeed permissible to purchase shares of a corporation as one would invest in a small business. The risk associated with either is still a business risk as a corporation can go bankrupt and a small business can also fail, too. But, the problem lies with some Muslim investors as they may be day-trading a particular security and their intention is to simply “buy low and sell high”. While some may interpret this as gambling, day-trading isn’t left entirely up to chance as there other factors at play (interest rates, options expirations, buy/sell ratio, earnings speculation, etc).

At this point, if one agrees that the purchase and sale of common shares is acceptable, then it is appropriate to investigate other instruments that tie into these procedures, such as buying on the margin. Buying on margin is when one borrows money from a broker/dealer to purchase a particular security. If the investment fails, money is lost and the purchaser would still need to reimburse the broker at a certain interest rate. From an Islamic perspective, this would be akin to gambling as an investor is speculating that the price of a security will rise at a rate that exceeds the prescribed interest rate on the loan for the buy on margin. When compared to owning common shares without employing a margin purchase, the loss is limited to the capital invested (i.e. should the share price drop to 0). Most Islamic scholars agree that purchasing common shares is permissible (Ross, N/A) as the risk involved is similar to owning one’s own business. The hope is that one invests in a company so that it will succeed. This leads us to another type of investment vehicle that would be prohibited in Islamic finance and that is “short-selling” a security. A short sale of a security is when an investor sells shares of a security that he/she may not own. This “naked” type of short sale is perhaps the riskiest type of investment as the potential losses are unlimited (not to mention that the investor is speculating a downfall for the company). Also, according to hadith, one should not sell that which he does not own (Nasa’i, Book 44, Hadith 165).

According to Naughton & Naughton (2000), “short selling and margin trading are severely restricted (pg. 145).” The authors continue to say that, “the use of stock index and equity futures and options are also unlikely to be acceptable within an Islamic market (pg. 155).” There is more grey area here as some scholars have stated that writing “covered calls” are permissible. In this case, an investor owns shares of a particular security and is willing to part with those shares at a specific price if an option buyer is willing to exercise their right to buy. The common shareholder would’ve sold at the price anyway but would like to earn the extra premium on the sale of the call option. The "gamble" here is on the part of the buyer of the call option and thus beyond the realm of the common shareholder as the buyer is speculating on an increase in the share price of the security above the strike price (plus the premium paid) while the seller of the option essentially is waiting for the option to expire. But, one might argue that a Muslim should not engage in practices that allow others to do what is prohibited. For example, a Muslim should not own a liquor store or sell pork products as both are prohibited even if he/she does not consume them they are enabling others to consume them. On the other hand, there are those who state that these are necessities in business as is the case when a Muslim works at a bank holding company providing loans and/or investment advice in congruence with conventional finance vehicles.

Bridging the Gap

In order to bring about a better understanding of Islamic finance we decided to compare Sukuk bonds with conventional bonds as some state that they have similar characteristics. Sukuk bonds, commonly known as Islamic bonds, are bonds based under Shariah law and are not (supposed to be) based on interest. They are an investment vehicle that seeks the preservation of capital and offers creditors a priority to common shareholders in the event of liquidation/bankruptcy. These bonds often represent a company and are typically backed by an asset. Afshar (2013) explains that there are two types of Sukuk bonds: asset-based and asset-backed. In an asset-based vehicle, the holders are creditors and have no rights over the hard asset itself. On the other hand, in an asset-backed vehicle, the owners have recourse to the asset itself as they are owners of the asset.

If we switch gears and evaluate conventional bonds we see that asset-based Sukuk bonds are similar in that both seek to preserve the initial capital invested in the vehicle. Both also have similar risks associated with the investment. In the United States, bondholders are exposed to inflation risk, interest rate risk, and of course default risk. The same is true for Sukuk holders of an asset-based vehicle. Now, consider asset-backed vehicles and their potential returns on investment. In this case, the bondholder is actually an owner and their coupon payment is directly linked to the profit generated from the asset. It is not seen as a debt instrument but yet the intention is to also preserve the initial investment. But how does this differ from a conventional revenue generating bond? Besides the obvious of a corporate issued bond versus a municipality, both rely on revenue to repay investors and reward them for their investment. A toll road may be built through a revenue bond and the tolls paid will go towards the cost of building, maintenance, and interest or reward. Hassouna & Thoumi (2010) proposed a model for the Perak State Parks Corporation (in Malaysia) in which park entry fees can be used to repay bondholders. Yet interest is prohibited in Islam but according to these types of bonds, there is essentially no danger to the initial capital as is seen when one owns common shares of a security. So in this case, a Sukuk bond is more in tune with a conventional bond than owning common shares of a corporation.

Next, consider a zero coupon bond and how similar it is to certain types of Sukuk. In both cases the investor expects to receive a nominal amount at the end of the term. In the United States, the investor in a zero coupon bond will likely declare the implicit interest earned each year on his/her taxes until maturity as there is no coupon rate and it is expected that the purchase price of the bond is heavily discounted. In a Sukuk bond, an investor pays a discount to receive a nominal amount at maturity.

The difference may lie in the terminology. For example, instead of "interest" paid to a bondholder, "dividend" or "income" may be paid to a Sukuk holder. Interest may be based on the credit rating and type of investment vehicle, while income should be based on the future earnings that the underlying asset generates to the Sukuk holder.

The following table is taken from Afshar's (2013) article on Sukuk bonds and summarizes the differences between asset based sukuk and asset backed sukuk:

Asset Based Sukuk	Asset Backed Sukuk
1. No right over assets	1. Recourse to assets
2. Risk with originator	2. Risk with assets
3. Assets are used as security interest	3. Securitization
4. Sukuk holders are creditors	4. Assets are ownership interest
5. Assets remain on originator's book	5. Sukuk holders are owners
6. In case of sales of assets, investors receive their face value, all excess goes to the originator	6. Financial and legal due diligence are detailed because investors are paid from the asset's cash flow and redemption
7. Recourse to originator	

Unfortunately, these are not used in practice as most Sukuk bonds are indeed asset- based (Reuters, 2007). In fact, El-Gamal (2009) states that Islamic finance has "done little more than mimic conventional financial products less efficiently, through multiple spurious trades, leases, and special-purpose-vehicle trading partners, thus increasing rather than reducing social and financial risks (pg. 32)." This certainly defeats the spirit of compassion associated with Islam as when one loans money it is in fact better to forgive the loan entirely (Quran 2:280).

What is "Permissible"?

So far mentioned in this article, we have highlighted what is forbidden in Islamic finance. As one can see, each *haram* is justified with its definition and how others can easily utilize these techniques in their own best interest while harming others. If anything, gambling and interest are prohibited but investments that involve business risk are not. According to the body of literature that has been cited, bonds are considered to be permissible in Islamic finance. This is because, as we discussed before, asset-backed investments, that are under Shariah law, hold essentially as much value as Sukuk bonds as do their asset-based counterparts. While some claim that in one case it's permissible and the other it is not, the Sukuk bonds do not seem to look like an investment but more of a loan. If one were to employ the verse from the Quran (2:275), it still seems puzzling how Sukuk bonds are akin to trade and not interest. To that end, people who are concerned about "Shariah-compliant" investment vehicles, we say that there really is no need to worry as there are striking similarities with conventional vehicles and in the case of common shares or mutual funds, they can be identical. In fact, the liquidity requirements of many Islamic banks are much higher in order to avoid borrowing from other banks with interest. Thus conventional bank holding companies have the advantage to be more profitable for they are allowed to use commercial paper and pay interest on these short-term loans to increase their liquidity and they are not bound to investing in corporations that are "halal" and free of interest (Hanif, 2011). But while this lack of accessible liquidity does not allow for growth opportunities in the Islamic financial arena, it is important to note that it does minimize the risk of default.

Also, common shares of a corporation's stock that is "halal" is permitted. A company can be deemed consistent with Islamic finance as long as it does not consist of any of the following: "produce, sell, trade, or distribute pork-related products; engage in pornography or obscenity; engage primarily in the entertainment business; engage in gambling, casinos, lotteries, or related businesses; conduct conventional financing or insurance; produce weapons or are involved in the defense industry; or produce, sell, trade or, distribute alcoholic beverages, tobacco or related products (McMillen & Issa pg. 334, 2010)."

Tautologically, a devout Muslim should invest primarily in Islamic Financial Institutions. While reasonably protecting one's capital, one should should not be led astray and indulge in the business of loaning. Whether capital is being received or bestowed to another party on a lending basis, one should keep away from such practices. This is considered *haram.* One last alternative vehicle to consider is *Ijara* which is permissible in IFIs. *Ijara* is a "rent-to-own" process where, for example a person may wish to purchase a vehicle but does not have sufficient funds for an outright purchase. The person would ask an Islamic bank to purchase the vehicle for them. The bank would purchase the vehicle and would later sell it to the consumer at a price higher than the initial charge. With this, the person can pay off the vehicle in installments to the bank. "Ijara [is] where the owner rents equipment or real estate to end-users against fixed-rental for a specific period, but without the option of ownership for the lessee. Thus, responsibility for maintenance and insurance rests with the lessor (Siddiqi, pg. 40, 2008)."

Conclusion

In this paper, we attempted to provide characteristics between conventional and Islamic vehicles, specifically as it relates to bonds. There are two concerns affecting investments made by practicing Muslims: (1) that the investment vehicle should not be associated with gambling and (2) that the preservation of capital is not akin to interest nor similar to it by a different name. The purpose was not to debate whether or not bonds are truly Islamic but rather to shed some light on their similarities in the hopes of addressing concerns by the general public.

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ABSOLUTE COMPETENCE OF COURTS ON ISLAMIC BANKING DISPUTE RESOLUTION IN INDONESIA

by Yeni Salma Barlinti[2]

Abstract

This paper will discuss the issue of absolute competency of courts in Indonesia on Islamic Banking Dispute Resolution. Differences of provisions concerning islamic banking dispute resolution effected legal resolution and concequences differently. On Article 49 Law of Religious Judicature, it is determined that religious court has absolute competency to resolve islamic economics dispute, include islamic banking. On Article 55 Law of Islamic Banking, not only religious court who has the authority but also civil court as long as the parties are agree and write it on the contract. The *choice of forum* in islamic banking dispute resolution has a chance to create disparity of verdicts and legal uncertainity. Eventhough the Law of Islamic Banking ditermines civil courts to use islamic principles in solving of islamic banking case, the courts is not used to use islamic law for legal consideration. In 2013, Constitutional Courts decided the competency issues of islamic banking dispute resolution on Verdict No. 93 of 2012. The verdict doesn't state expressly whether civil court still has the authority or not. The development of this issue will be described, as well as legal analysis of the constitutional court verdict.

Keywords:

Islamic banking, dispute resolution, religious court, civil court

A. Introduction

The practice of Islamic banking in Indonesia was started with academic studies on bank interest. The issue of comparison of bank interest and usury (*riba*) becomes very important to get the answer because usury (*riba*) is forbidden in Islam, also considering the majority of the population in Indonesia is

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Muslim.[3] The idea of the establishment of Islamic banks in Indonesia were discussed in a national seminar on "Relationship Indonesia - the Middle East" in 1974 and an international seminar organized by Lembaga Studi Ilmu-ilmu Kemasyarakatan and Yayasan Bhineka Tunggal Ika in 1976[4]. By reasons of the absence of regulations, the political element which connoted the religious ideology, and the capital that did not exist, the establishment of Islamic banks could not be realized at that time.[5]

In 1991, the establishment of new Islamic bank was accomplished by the establishment of Bank Muamalat Indonesia, as the first Islamic bank in Indonesia. The presence of Bank Muamalat Indonesia gave huge impact to islamic economic implementation in other sectors, such as islamic insurance in 1994[6], islamic capital market in 1997[7], and islamic financing in 2000[8]. In carrying out islamic economic activities, all islamic economic actors should be based or primary guided to the Qur'an and the Hadith. Nevertheless, the provision in the Qur'an and the Hadith is not enough to be practical terms because it

[3]Discussion regarding bank interest whether *riba* or not has been discussed by the two largest Islamic society organizations in Indonesia, Muhammadiyah and Nahdlatul Ulama (NU) for long time. Muhammadiyah through Muhammadiyah Congress in 1968 through the Legal Affairs Committee of Muhammadiyah Sidoarjo decided that the law on bank interest granted by the state-owned banks to their customers or otherwise is *mutasyabihat*. Nahdlatul Ulama through the 2nd Congress on October 9, 1927 in Surabaya, stipulated that the law on bank and the interest is forbidden for prudence. In Great Conference Syuriah NU on March 19, 1957 in Surabaya, NU considered that the interest in the company (banks and cooperatives) in an emergency. See Atang Abd. Hakim, *Fiqih Perbankan Syariah: Transformasi Fiqih Muamalah ke dalam Peraturan Perundang-undangan*, Bandung: Refika Aditama, 2011, pp. 75-81.

[4]Atang Abd. Hakim, *Fiqih Perbankan Syariah: Transformasi Fiqih Muamalah ke dalam Peraturan Perundang-undangan*, Bandung: Refika Aditama, 2011, p. 44.

[5]Atang Abd. Hakim, *Fiqih Perbankan Syariah: Transformasi Fiqih Muamalah ke dalam Peraturan Perundang-undangan*, Bandung: Refika Aditama, 2011, p. 44-45.

[6]In 1994, PT. Syarikat Takaful Indonesia (STI) as the first Islamic insurance company in Indonesia was established, pionered by Ikatan Cendekiawan Muslim Indonesia (ICMI) through Yayasan Abdi Bangsa, Bank Muamalat Indonesia, PT. Tugu Mandiri Life Insurance, Ministry of Finance, and some Indonesian Muslim businessmen. See "History of Islamic Insurance Indonesia", http://www.republika.co.id/koran_detail.asp?id=327164&kat_id=400, accessed on August 7, 2007.

[7]Islamic capital markets beginning with the first issuance of Islamic mutual fund is a mutual fund Danareksa Syariah on June 25, 1997 and was followed by the issuance of Islamic bonds in late 2002, as well as the presence of the Jakarta Islamic Index (JII) on July 3, 2002 by the Jakarta Stock Exchange (JSE). See Tim Studi Tentang Investasi Syariah di Pasar Modal Indonesia, "Studi Tentang Investasi Syariah di Pasar Modal Indonesia", Departemen Keuangan RI Bapepam, Proyek Peningkatan Efisiensi Pasar Modal Tahun Anggaran 2004, p. 2.

[8]Opportunity to conduct sharia financing opened by the government with the enactment of Decree of the Minister of Finance No. 488 / KMK.017 / 2000 on Financing Company, in Article 7 paragraph (1), "In conducting its business, the Financing Company may give financing based on Syariah Principles." (*"Dalam menjalankan kegiatan usahanya, Perusahaan Pembiayaan dapat melakukan pembiayaan berdasarkan Prinsip Syariah."*) Definition of Sharia Principles (Article 1 letter j) is the "rule of treaty based Islamic law between financing companies and other parties to perform in accordance with Shariah financing " (*"aturan perjanjian berdasarkan hukum Islam antara Perusahaan Pembiayaan dengan pihak lain untuk melakukan pembiayaan sesuai dengan Syari'ah"*).

does not specifically regulate. The economics in the Qur'an and the Hadith is general principles, such as the principle of profit and loss sharing and the prohibition of usury (*riba*), *maysir*, and *gharar*.

B. Regulations of Islamic Banking Dispute Resolution

In implementing of Islamic banking activities, as well as other Islamic economic activity, dispute between actors is possibly occured. In this situation, both parties require the judiciary to prosecute their case. In Indonesia, there are two judiciaries that have authority to resolve civil cases, i.e. civil courts and religious courts. The authority to resolve islamic banking cases was an issue. In principle, banking dispute is civil courts' authority to resolve. However, many people doubt the judges in the mastery of Islamic law, because the judges do not use Islamic law in prosecuting their cases. Islamic law is used by the judges in religious courts, because their cases are related to Islamic law. Legal issues that occur were religious courts have no authority or absolute competence to resolve the case of Islamic banking (Islamic economics in general).

In response to the needs of the Islamic economic agents, including Islamic banking, the government issued Law No. 3 of 2006 on the Amendment of Law No. 7 of 1989 on the Religious Judicature. Specifically related Islamic banking dispute settlement, there are also provisions in Law No. 21 of 2008 on Islamic Banking.

1. Law on Religious Judicature 2006

In 2006, Law No. 3 of 2006 on the Amendment of Law No. 7 of 1989 on Religious Judicature (Law on Religious Judicature 2006) was applied and changes the provisions of the absolute competence of religious courts. The change is to add the field of dispute, i.e. the dispute of islamic economics.[9] Article 49 of Law on Religious Judicature 2006 determines that the settlement of disputes in the field of Islamic economics is becoming religious court's jurisdiction. The explanation of Article 49 states that the

[9]Earlier, the Article 49 of Law on Religious Judicature 1989 determined that religious courts have the authority to settle cases between people who are Muslims in the field of marriage, inheritance, wills and grants based on Islamic law, as well as endowments and *Sadaqah*.

reference to "Islamic economy" in Article 49 of whom are Islamic banking.[10] The provisions in this law indicates that any disputes of islamic economy, including Islamic banking, is the authority of the religious courts to resolve.

2. Law on Islamic Banking

The applicability of Law No. 21 of 2008 on Islamic Banking (Law on Islamic Banking) in 2008, the article does not give the same rule to the provisions of Article 49 of Law on Islamic Judicature 2006. The Article 55 of Law on Islamic Banking determines that,

(1) Penyelesaian sengketa Perbankan Syariah dilakukan oleh pengadilan dalam lingkungan Peradilan Agama.

(2) Dalam hal para pihak telah memperjanjikan penyelesaian sengketa selain sebagaimana dimaksud pada ayat (1), ***penyelesaian sengketa dilakukan sesuai dengan isi Akad****.*

(3) Penyelesaian sengketa sebagaimana dimaksud pada ayat (2) tidak boleh bertentangan dengan Prinsip Syariah.

(1) Islamic banking dispute resolution resolved by the court within the Religious Courts.
(2) In the event that the parties have agreed on dispute resolution other than as referred to in paragraph (1), the dispute resolution carried out in accordance with the contents of the Agreement.
(3) Settlement of disputes referred to in paragraph (2) shall not be inconsistent with islamic principles.

Definition of "dispute resolution carried out in accordance with the contents of the Agreement" described in the elucidation of Article 55 paragraph (2). They are deliberation, banking mediation, Badan Arbitrase Syariah Nasional (Basyarnas) or National Islamic Arbitration or other arbitrations; and/or the courts in the Civil Judicature.

[10]The meaning of "islamic economics" is the act or business activities conducted according to the principles of Shariah, include: a. islamic banks; b. islamic microfinance institutions; c. islamic insurance; d. islamic reinsurance; e. islamic funds; f. Islamic bonds and islamic medium-term commercial paper; g. islamic securities; h. islamic financing; i. islamic pawn; j. islamic financial institution of pension funds; and k. islamic business.

C. Legal Issue: Choice of Forum of Islamic Banking Dispute Resolution

Regulation for islamic banking dispute resolution in Law on Religious Judicature 2006 and Law on Islamic Banking, raises question, which Law applies to resolve disputes about Islamic banking? The applicability of both Laws shows disharmony as they both set the same thing but specify different things. The similarity is set up dispute resolution on Islamic economics, Islamic banking in particular. The difference is the authority to the different courts, i.e. Law on Religious Judicature 2006 gives the authority only to the religious courts, and Law on Islamic Banking gives the authority not only to the religious court but also civil court.

Civil court and religious court have different characteristics. Persona characteristics on the Religious Court is the dispute only between people (legal subjects) who are Muslims. Definition of people who are Muslims is a person or legal entity by itself voluntarily subjecting themselves to the Islamic law on matters within the authority of the Religious Courts. While people who seeking justice in the Civil Courts is called by the people in general.[11] Characteristic of the fields of disputes on the Religious Courts are the disputes based on Islamic law (private law), while on the Civil Courts is the private and criminal disputes.[12] Characteristic of law used to resolve the dispute in the Religious Courts is Islamic law and other laws that are not contrary to Islamic law, while in the Civil Courts is another law applied in Indonesia in addition to Islamic law.[13] Characteristic of requirements of judges at the Religious Courts are Bachelor of Islamic law or Bachelor of law who master the Islamic law, while judges at the Civil Courts is only Bachelor of law.[14]

In practice, Islamic banking disputes conducted in both these jurisdictions. Not infrequently, the formal legal issues arise in the case submitted to the religious court or the civil court.

D. Judicial Review of Article 55 of the Law on Islamic Banking (Verdict of Constitutional Court No. 93 / PUU-X / 2012)

[11]Elucidation of Article 49 of Law on Religious Judicature 2006 and the General Elucidation of the Law No. 2 of 1986 on the Civil Judicature.

[12]*Ibid.*

[13]*Ibid.*

[14]Article 13 paragraph (1) of Law No. 50 of 2009 and Article 14 paragraph (1) of Law No. 49 of 2009.

There was an Islamic bank customer felt aggrieved with the provisions of Article 55 Law on Islamic Banking. Therefore, he filed a Judicial Review on this article. The reason put forward that the article creates legal uncertainty, in paragraph (1) the article has confirmed that the court is authorized to settle disputes Religious Court. This paragraph contrary with the paragraph (2) of the article which determines that the parties to Islamic banking transactions are allowed to use the Civil Court. This contradictory provision raises different interpretations so that the meaning of the rule of law becomes uncertained.[15]

The judicial review, the Constitutional Court decided by Verdict of Constitutional Court No. 93 / PUU-X / 2012 in August 29, 2013 remove the elucidation of Article 55 paragraph (2) Law on Islamic Banking. The decision is as follows.

a. *Penjelasan Pasal 55 ayat (2) Undang-Undang Nomor 21 Tahun 2008 tentang Perbankan Syariah (Lembaran Negara Republik Indonesia Tahun 2008 Nomor 94, Tambahan Lembaran Negara Republik Indonesia Nomor 4867) bertentangan dengan Undang-Undang Dasar Negara Republik Indonesia Tahun 1945*
b. *Penjelasan Pasal 55 ayat (2) Undang-Undang Nomor 21 Tahun 2008 tentang Perbankan Syariah (Lembaran Negara Republik Indonesia Tahun 2008 Nomor 94, Tambahan Lembaran Negara Republik Indonesia Nomor4867) tidak mempunyai kekuatan hukum mengikat*

a. Elucidation of Article 55 paragraph (2) of Law No. 21 of 2008 on Islamic Banking (State Gazette of the Republic of Indonesia Year 2008 No. 94, Supplement to State Gazette of the Republic of Indonesia No. 4867) contrary to the Constitution of the Republic of Indonesia of 1945.
b. Elucidation of Article 55 paragraph (2) of Law No. 21 of 2008 on Islamic Banking (State Gazette of the Republic of Indonesia Year 2008 No. 94, Supplement to State Gazette of the Republic of Indonesia No. 4867) has no binding legal force.

Elucidation of Article 55 paragraph (2) can be interpreted that the parties (customers and Islamic banks) have limited forms of dispute settlement in addition to the Religious Court (Article 55 paragraph (1)), The forms are deliberation, mediation, arbitration, and litigation on the Civil Court. Deleting elucidation of Article 55 paragraph (2) Law on Islamic Banking Law in the Constitutional Court's verdict does not eliminate the problem of choice of forum in dispute resolution of Islamic banking. Precisely expand the interpretation of the phrase "dispute resolution carried out in accordance with the contents of the

[15]Verdict of Constitutional Court No. 93 / PUU-X / 2012.

Agreement". No more restrictions on other forms of dispute resolution other than the Islamic banking through Islamic Court.

E. Closing

Legal issues regarding choice of forum Islamic banking dispute resolution, can be unresolved. This is due to the interpretations of the content of the Verdict of Constitutional Court No. 93 / PUU-X / 2012. Although firmly decided that the elucidation of Article 55 paragraph (2) Law on Islamic Banking does not have binding legal force, then the force is Article 55 paragraph (2) without explanation. If reading grammatically, the provisions of Article 55 paragraph (2) This can be interpreted to mean that the parties are free to determine the form of the settlement of a dispute between them along the agreed upon and set forth in the contract. Freedom to choose form of dispute resolution providing the widest freedom, including choosing the civil court.

Not enough just to read the contents of the verdict itself, but need to read and understand the entire contents of the Verdict is to better understand the purpose of declaring the contents. Constitutional Court intends to give authority to the religious court in the settlement of Islamic banking, like Law on Religious Judicature 2006.

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The Annual Intellectual Symposium of Islamic Financial Economics was held in University of London: The Senate House: Torrington Room on May 28th, 2014. The symposium has been organized by ECO-ENA: Economics & ECO-Engineering Associate, Inc. ®, Canada

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May 28th, 2014

Symposium Chair: Dr. Ghada Gomaa A. Mohamed, ECO-ENA, Inc. ®, Canada

Main Speakers:

Professor Jassim Ali AlShamsi, United Arab Emirates University, *UAE*

Professor Mohammad S. AlJarf, Faculty of Islamic Economics and Finance, Umm Al-Qura University, *KSA*

Professor Rodney Wilson; Durham University, *UK* (*Over - Skype*)

Dr. Ghada G. Mohamed; Islamic Economics & Islamic Finance Forum @ ECO-ENA, Inc. ®, *Canada*

Dr. Mohga Bassim, University of Buckingham, *United Kingdom*

Dr. Najeh Mzoughi, College of Business Administration, Jazan University, *KSA*

Dr. Nidal AlSayyed, Inayah Research & Consulting, University of Jordan, *Jordan*

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Mr. Alim Al-Ali, University of London, *United Kingdom*

Venue: University of London: The Senate House: Torrington Room

London, United Kingdom

May 28th, 2014

Symposium Program

9:00 am - 9: 30 am Reception: Coffee & Refreshments

9:30 am to 12:00 Presentations

English Session

9:30 am - 10:00 am - Paper (1-1)

10:00 am - 10:30 am - Paper (1-2)

10:30 am - 11:00 am - Paper (1-3)

11:00 am - 11:30 am - Paper (1-4)

11:30 am - 12:00 (Open Questions & Discussions)

12:00 - 1:00 pm Lunch break (Delegates are invited)

1:00 pm to 3:00 pm Presentations

English Session

1:00 pm to 1:30 pm - Paper (2-1)

1:30 pm - 2:00 pm - Paper (2-2)

2:00 pm - 2:30 pm - Paper (2-3)

2:30 pm - 3:00 pm - (Open Questions & Discussions)

3:00 pm - 3:30 pm Coffee Break and Refreshments

3:30 pm to 5:00 pm Presentations

Arabic Session

3:30 pm - 4:00 pm - Paper (3-1)

4:00 pm - 4:30 pm - Paper (3-2)

4:30 pm - 5:00 pm - (Open Questions & Discussions)

5:00 pm: ***Closing with a Gathering for Chat and Dessert***

Venue: University of London: The Senate House: Torrington Room

London, United Kingdom

May 28th, 2014

<u>Paper Presented</u>:

Paper (1-1): "Islamic Sukuk: Economic Benefits and Political Risk" by Ghada G. Mohamed.

Paper (1-2): "Global Achievements and Prospects for Expansion in Islamic Finance" by Rodney Wilson.

Paper (1-3): "A CAPM for Mixed Islamic Conventional Markets with an Application to the Valuation of Islamic Investment Accounts" by Ahmed Badreldin.

Paper (1-4): "Monetary Policy in an Islamic Economy: The Existence and Role of the Central Bank" by Gabriella Crimi, George Naufal & Ismail H. Genc.

Paper (2-1): "Islamic Economics: Connecting Universities along the E-Skills Road" by Mohammad S. AlJarf.

Paper (2.2): "Investigating Shariah and Liquidity Risk Factors in Special Purpose Company and its Role in Structuring Contemporary Waqf Sukuk" by Nidal AlSayyed.

Paper (2-3): "The Idea of a Single Currency: A GCC Case in Perspective" by Najeh Mzoughi.

Paper (3-1): "Islamic Market for Securities in the Light of the decisions of Islamic Jurisprudence Academies between Hope and Reality" by Jassim Ali AlShamsi.

Paper (3-2): "Islamic Sukuk" by Nidal AlSayyed – *Panel Discussion*

Paper (3-3): "Islamic Economics & Islamic Finance: Conceptual Foundation" by Mohga Bassim – *Panel Discussion*

Venue: University of London: The Senate House: Torrington Room

London, United Kingdom

May 28th, 2014

Selected Working Papers and Articles

Presentation URL of some papers are also included.

- **Islamic Sukuk: Economic Benefits and Political Risk**

Ghada Gomaa A. Mohamed; The Islamic Economic Forum @ ECO-ENA, Inc., Canada

Presentation URL:

http://nebula.wsimg.com/ae5704faa4798fad88ca5e503b093676?AccessKeyId=74B254A8F08BF04F4DC1&disposition=0&alloworigin=1

- **Global Achievements and Prospects for Expansion in Islamic Finance**

Rodney Wilson (Professor); Durham University, United Kingdom

Presentation URL:

http://nebula.wsimg.com/7cebc955c222211bcfa3cf311e854477?AccessKeyId=74B254A8F08BF04F4DC1&disposition=0&alloworigin=1

- **A CAPM for Mixed Islamic Conventional Markets with an Application to the Valuation of Islamic Investment Accounts**

Ahmed Badreldin; Phillips University of Marburg, Germany

Presentation URL:
http://nebula.wsimg.com/dff5e0701ecd3bb9ed24e88cf23df7e0?AccessKeyId=74B254A8F08BF04F4DC1&disposition=0&alloworigin=1

- **Monetary Policy in an Islamic Economy: The Existence and Role of the Central Bank**

Gabriella Crimi, Mount Holyoke College and the American University of Sharjah

George Naufal, The American University of Sharjah

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- **The Idea of a Single Currency: A GCC Case in Perspective**

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The Idea of a Single Currency: A GCC Case in Perspective

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Abstract:

The role of the U.S. dollar as world reserve currency is likely to be reduced as its economic pre-eminence diminishes. Yet no other single currency will be able to catch up. However, most GCC currencies are pegged to the U.S. dollar t in contrast of countries around the world which continue to diversify their foreign exchange reserves.

Recently, a trend has already started in some countries of the GCC, like Kuwait, to remove the peg and replace it by a basket of currencies. The common perspective is to install a monetary union with a single currency. Unfortunately, majority of financial opinions feel that such objective can be reached by 2020, but not actually. Under the baseline scenario of the EIU, GCC countries are unlikely to remain on a fixed exchange rate as a force for stability and a nominal anchor to reassure investors and trading partners.

It is possible the application of a single currency for the GCC countries and benefit from the problems of the euro area, but the formation of this agent Union needs more time for the rest of the monetary and fiscal reforms, the aim of the establishment of a sound economic structure and development of rules valid to avoid the crises associated with monetary policy or fiscal policy.

At a time when the monetary union would be a real support for the growth of Gulf economies, it is now necessary to diversify these economies rather than just oil. In the case of a State Council, positive effects of the common currency tied to the positive effects in terms of monetary and fiscal policy and financial commitment to the convergence criteria are those standards of the factors helping to attract more foreign investments and to intra-GCC.

The objective of this paper is to examine the feasibility of monetary union for GCC countries, and to discover some of the operational issues that may arise in such arrangement. The main idea is to see if the thesis stating that a basket of currencies is always better than a single reference currency due to negative impacts of any fluctuating evolution of its value against other currencies, can be applied in the case of GCC countries.

Introduction

The Gulf Cooperation Council (GCC) Managed to achieve major steps worthy of attention and study among the most important experiences of economic and monetary integration in the world. Though this experience simulates the steps of integration between the countries of the European Union, but there are some characteristics that distinguish this model from the European experience such as language, religion, shared history. Also, the countries of the region are close in many of the economic characteristics; such as the oil wealth constituting two thirds of total GDP of the GCC countries, and three-quarters of government revenues and annual exports, and the stock of about 40% of the world's proven reserves of oil, and 23% of gas reserves, contributing to oil revenues in support infrastructure which is reflected positively on the economic development in the region.

The Gulf Arab states began the process of economic integration through the signing of the Unified Economic Agreement that have developed ambitious structure of integration including trade cooperation, and regulating the movement funds and personnel, economic activity, coordination development technical support, and cooperation in the field of transport and communications, as well as financial and monetary cooperation. Hence, a systematic economic integration begun in the area of free trade, then the customs union, then the Common Market to ensure that movement of goods, capital and labour, followed by the stage of economic union in which the coordination of trade and economic policies between the States Parties; to come - after that - the stage of monetary union, which is the summit economic integration; where the monetary policy of the group states is unified, and a common currency replaces national currencies.

Recently, there is a growing interest about the monetary union and its positive impact on the Gulf countries and the welfare of the citizen; because of the increasing challenges faced by the economies of the region in light of the phenomenon of globalization, and liberalization of international trade, and the internationalization of production, and increasing power of economic blocs. In this context, varied studies and theoretical discussions were carried on the GCC monetary union, the challenges facing the success of the single currency, the preferred choice for the peg appropriate for the economies of the Gulf, the feasibility of linking GCC currency to the dollar, especially with the imminent entry of the GCC monetary union into the application, structural changes defined by the GCC economies in light of the growing trade relations and financial Asia and emerging economies, and negotiations with the European Union to create a free trade area expanded, in addition to oscillations that are known to the dollar peg from time to time, and the increasing volatility in recent years.

All these evolutions had a negative impact on the these countries, and called the revision of this exclusive, special, and strict relationship with the dollar, and the search for better options for the region in line with the rules of independence, aiming to achieve monetary union by the central bank and single currency, which was the announcement of its establishment in Riyadh in 2009. This study presents an analysis of the scientific debate about most suitable exchange rate policy for Gulf currency regarding to these new circumstances.

I Controversy about the advantages and disadvantages of Gulf currency pegs:

1 Different trends for the selection of the peg for the GCC Countries

Many studies and theoretical discussions about the most appropriate currency of linkage to the economies of the Gulf, especially with the approach of the GCC monetary union entered into force. The results of some of these studies can be classified into three streams or trends:

1. The first trend: The difficulty of disengagement requires the need for continued link of Gulf currencies with the dollar. The process needs to be studied in depth in order not to subject the region to the negative effects resulting from the costs of disengagement, as well as the attachment to dollar reflects the weight of this currency for revenues resulting from the sale of oil priced in dollars, and most of its investments abroad denominated in dollars.
2. The second trend: a pro-disengagement movement, using the experience of Kuwait in this area, which re-pegged to a basket of currencies in 2008 instead of the dollar.
3. The third trend: it is a compromise between the current direction, and calling to find other alternatives, and not to be drawn behind the U.S. central bank interest rates, and to consider the revaluation of GCC currencies against the dollar in order to avoid repercussions on the dollar itself.

Based on this classification, candidate states more likely than others to take advantage of the strong linkage to foreign currency exchange rates, are (Alesina, Barro & Tenreyo 2002):

a. states failing to achieve financial and monetary stability and ensure price stability alone,
b. states linking economic crisis significantly with crises of state or economic bloc of peg currency,
c. small countries that depend - significantly - on foreign trade, and
d. states close geographically, linguistically, and border of countries of peg currencies.

According to the researchers, it may be justified the link to foreign currency and the judgment on its merits, based on a set of criteria that must be met for countries that seek to use foreign currency. Such as the expansion in foreign trade which may result from the area of currency, the capacity to influence the degree of common action of prices and production, and the reduction of inflation from linking currency with low inflation.

2 Is disengagement from dollar economically justified?

First, *any depreciation of the dollar against foreign currencies, in particular euro and the yen led to the lifting of the import bill of Golf countries*. Opponents of the disengagement see that this justification is a kind of exaggeration; because of Golf's imports from the euro area does not exceed 25% of the total imports, while imports from Japan don’t exceed 9% of the Total imports.

Second, *the disengagement of Golf currencies from the dollar would fight inflation by reducing the costs of exports, and the reduction of unjustified price rises in the local economy*. Opponents believe that this justification is inaccurate, and doesn’t correspond to reality, because GCC economies didn’t suffer the problem of inflation in previous years of 2008. They call thereby the need to adopt strong measures to contain the impact of excess liquidity on price inflation of domestic assets, even if authorities responsible for monetary policy to raise interest rates.

Furthermore, the claim that the peg to the dollar is responsible for inflation neglects the effect of the following variables in the pressure levels of domestic prices: the impact of increased oil revenues, which led to an increase income levels, and then spending, and the impact of the explosive growth in liquidity cash on a scale not seen in GCC history (and the impact of big growth in the real estate sector and rising housing and rents prices, and the impact of massive spending plans and giant projects.

Supporters of disengagement from dollar consider that basket system provides relative flexibility in determining the exchange rate, and contributes to strengthening the capacity of the local economy to absorb the impact of high volatility, especially in the short-term exchange rates of major currencies in global markets. Accordingly, imports cost from developed countries seems cheaper than before, as well as that in case of any dollar's decline on the international financial markets Golf currencies don't depreciate automatically; due to weak link between them. Also, the disengagement will modify the relative values of Oil exports sold in dollars and of foreign investment income.

The success of the single currency requires a single monetary policy and a fixed exchange rate system, difficult to achieve in the case of a basket of currencies compared to a link with dollar, as well as the GCC economies depend heavily on oil denominated in dollars, and when preparing their budgets calculated on the basis of resource contracts generated from oil imports. Hence, the disengagement from dollar will be extremely dangerous to the economies of the Gulf, and would prevent the achievement of a common currency.

2 Is it better to link GCC currency to a basket of currencies

As for the Gulf countries, the choice of peg varies according to the following three criteria (Fabio Askhakilani and others, 2009):

- If the trade is the only criterion; euro will be chosen as a best fulcrum currency for the countries of the region.

- The adoption of the euro and the yen as two pegs currencies linking Saudi Arabia and the United Arab Emirates, in addition to Bahrain if the correlative link to the output is the norm, while Oman tend to choose the euro, while Qatar and Kuwait seem to be closer to the U.S. dollar peg.

- If the criterion is on the basis of price inflation; dollar may be the preferred option for the Gulf States.

It is clear from these results that the best solution for GCC is not the link to a single currency, but to a basket of currencies including the U.S. dollar, and the euro, the Japanese yen.

Furthermore, some other results (Nasser Saidi, 2002) indicate that for the Arab countries in general and the GCC countries, it will be better to peg especially in Euros rather than U.S. dollars given of the importance of trade links between the two parties. This alternative will be strengthened if there are any of the following cases:

- Establishment of economic integration between the countries of Europe, the Middle East, the GCC countries, and the European Union, and Coordinative implementation of the Greater Arab Free Trade (GFTA) as result of a Free trade agreement with the European Union and accession to the WTO.

- Innovation in payment arrangements through the expansion of the euro area to include the countries of the Mediterranean and Arab countries in the Middle East.

And also thinks Jdris Jadresic, 2002, there are other considerations for the GCC countries, as well as the competitiveness and the outside stability, to choose a currency linkage, including the credibility of the exchange rate position and cash, and the effects of exchange rate fluctuations on financial markets and wealth, and the cost of financial transactions. Unless significant gains are achieved of the shift from the dollar peg to another link, these considerations will dominate and support the decision to continue the dollar peg.

3 Oil Reserves can support the value of Gulf currency

This strategy consists in the rate system called the link of export price or Peg export price PEP (Frankel, 2005). This proposal is directed at countries which their economies are based on the production of primary commodities, whether mineral or agricultural, by installing the value of local currency price of the commodity. Countries that dependent on oil production can be linked to currency price of oil; and so on ...This attachment can be total or partial, through a basket consisting of oil and other currencies, and hence the value of currency can up and down depending on the price movement of oil in dollars.

We know that oil, in addition to being material non-renewable, it is a primary commodity characterized by cycles of sharp demand and supply, and the rise of prices and landing, as it happens in the last three decades. Since oil represents the main source of revenue for the GCC, so that stabilizing the exchange rate in relation to a currency or basket of currencies, the existence of these fluctuations and cycles of raw material prices, creates large economic problems to countries that peg their currencies to the dollar (Currency used for pricing of GCC oil exports) especially on the long term. In the case of low oil prices (lower revenues which are priced in dollars), the exchange rate seems high too much, and then it is difficult for monetary authorities to reduce the exchange rate for its negative effects (higher prices).

In the other case of high oil prices due to increased demand, and increased revenues, it would be more difficult to push the real exchange rate to rise, due to the stabilization of exchange rates, and then takes its way to increase in the short term, and that means higher exchange rate or the so-called Dutch disease. On this basis comes the proposal (Frankel 2005) to avoid unwanted changes in real exchange rates due to sharp fluctuations in oil prices, and to ensure best management of exchange system, central banks in GCC countries can retain reserves of oil to support the value of Gulf currency.

4 Gulf currency link to SDR unit have many Advantages

Also among the proposals (IMF Report 2008), we note that the special drawing rights (SDR) as a combination of the basket seems an appropriate link. In fact, the key advantage of a reference basket of currencies is its ability to fix the effective nominal exchange rate; thus isolate the economy from turmoil arising from fluctuations between major cross currencies. A basket of currencies reference is already a natural choice under float over, and the primary objective of this system is to reduce the deviation of real effective price; where the SDR basket enjoys great level of stability not enjoyed by any other currency, as it doesn't follow a specific country; thus not affected by the economic performance of this country or its trade balance, on the contrary, the fluctuations between the major currencies, which are often opposite are not reflected in the value of the SDR.

II Preferential exchange rate regime in the GCC Countries:

1 Choose any exchange rate currency depends on the nature economic goals

Table. 1 : Exchange rate regimes

Fixed arrangements	1. Currency union.
	2. Currency board (Dollarization)
	3. Fixed exchange rates
Intermediate arrangements	1. Adjustable link.
	2. Variable link.
	3. Basket of currencies.
Floating exchange rates	1. Oriented floating exchange rates
	2. Free floating exchange rates

To date there is no consensus to provide a convincing answer on the extent of preferential exchange rate regime compared to another system (Table. 1), but generally the selection of an exchange rate regime is based on economic objectives, and the source of shocks and structural characteristics of the economy under consideration. Also, the explanatory factors for the fluctuations of exchange between currencies vary according to the timeframe, the short term, medium and long term.

Hence we can say that Exchange rate is function of interlocking variables of quantity and quality of difficult to judge the importance of one without the other at all. Several studies indicate that the economic variables that can be affected by the policy of pegging are: foreign trade of the economy, the trade balance or current account, relative prices of goods traded to non-traded goods, the general level of prices, and real income of the local economy elements.

2 Most important measures for the success of Gulf monetary union

The monetary policy of GCC countries was based for years on the installation of fixing a strict currency exchange rate or group of currencies of other countries characterized by their monetary policy Stability. They have started officially from January 2003 in linking their currencies to the dollar as a first step towards monetary union (Table. 2). The Council states achieved many strides towards greater economy and financial integration through the establishment of a customs union and common market, reach agreement on the criteria for economic convergence, and the agreement to adopt a common currency.

Table. 2 : Exchange Rate Regimes in the GCC Countries

Currency	Exchange rate regime	Currency of the peg	Exchange rate against the dollar**
Bahraini dinar	A traditional fixed exchange rate	U.S. dollar	0.266
Kuwaiti dinar	Fixed exchange rates within horizontal bands	a basket of currencies*	0.352
Omani riyal	A traditional fixed exchange rate	U.S. dollar	0.260
Qatari riyal	A traditional fixed exchange rate	U.S. dollar	0.275
Saudi riyal	A traditional fixed exchange rate	U.S. dollar	0.267
UAE dirham	A traditional fixed exchange rate	U.S. dollar	0.272

* Components and weights of the basket of currencies still not known
** Average period

In this framework, the most recommended measures necessary to ensure the success of the monetary union include:

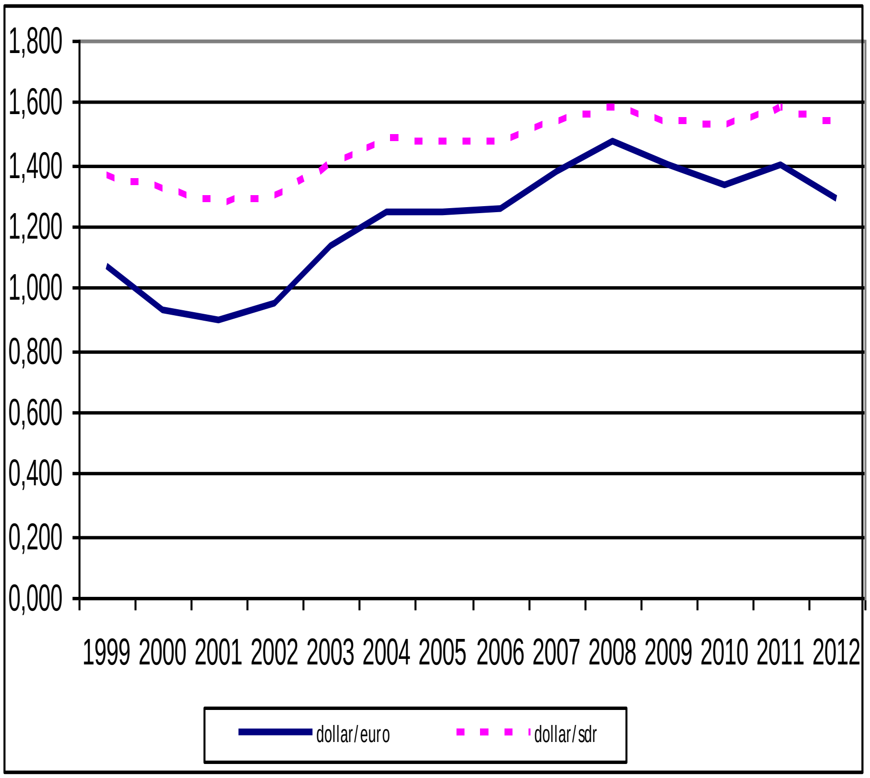
- the establishment of central bank characterised by decentralization, and shall be responsible for the management of monetary policy in coordination with Central banks of the GCC countries,
- development of adequate monetary instruments in conjunction with the establishment of a common Stock market,
- develop a system to manage financial crises,
- ensure the continued public finances through structural reforms, and a ceiling on the non-oil deficit in the budget, and on government debt,

- promote competition in the market through the enactment of laws and the development of appropriate rules and regulations,
- ensure the free movement of labour among the countries of GCC, and to address the pressures of increasing unemployment through appropriate policies for the wages and employment, and
- improve the transparency of policy and the issuance of macroeconomic data at the time and coverage.

3 Need to adopt an independent monetary policy and an appropriate exchange rate policy to support the monetary union

Before the launch of the GCC monetary union, it is necessary to achieve exchange rate stability by enhancing the relative stability of Gulf currencies in the face of other currencies especially the dollar, the stability of the prices level, the protection of economies against the local effects of imported inflation, avoid violent fluctuations in movements of capital, realize an economic growth, and diversification of sources of income. For this we present next some of the developments that emphasize the necessity of adopting independent monetary policy and an appropriate exchange rate policy.

<u>Graphic. 1:</u> Exchange rates, US dollar/Euro and US dollar/SDR 1999-2012



Source: Graphic made by the author based on data of European Central Bank and Pacific Exchange Rate Service

<u>Table. 3 :</u> Exchange rates of GCC currencies against the dollar, euro and SDR *

Period average 1999 - 2012

	Kuwaiti dinar	Qatari riyal	Omani riyal	Saudi riyal	Bahraini dinar	UAE dirham
1999	0,304	3,64	0,385	3,75	0,376	3,673
	0,324	3,879	0,410	3,996	0,401	3,913
	0,416	4,978	0,526	5,128	0,514	5,022
2000	0,307	3,64	0,385	3,75	0,376	3,673
	0,284	3,362	0,355	3,464	0,347	3,392
	0,405	4,799	0,507	4,944	0,496	4,842
2001	0,307	3,64	0,385	3,75	0,376	3,673
	0,274	3,259	0,344	3,358	0,337	3,288
	0,390	4,635	0,490	4,775	0,479	4,676
2002	0,304	3,64	0,385	3,75	0,376	3,673
	0,287	3,441	0,364	3,545	0,355	3,472
	0,394	4,716	0,498	4,858	0,487	4,758
2003	0,298	3,64	0,385	3,75	0,376	3,673
	0,337	4,118	0,435	4,243	0,425	4,155
	0,418	5,101	0,539	5,256	0,527	5,147
2004	0,294	3,64	0,385	3,75	0,376	3,673
	0,366	4,527	0,478	4,664	0,468	4,567
	0,436	5,393	0,570	5,556	0,557	5,441
2005	0,292	3,64	0,385	3,75	0,376	3,673
	0,363	4,529	0,479	4,666	0,468	4,569

	0,431	5,377	0,568	5,540	0,555	5,425
2006	0,290	3,64	0,385	3,75	0,376	3,673
	0,364	4,571	0,483	4,709	0,472	4,612
	0,428	5,365	0,567	5,527	0,554	5,413
2007	0,284	3,64	0,385	3,75	0,376	3,673
	0,390	4,989	0,527	5,140	0,515	5,034
	0,437	5,589	0,591	5,758	0,577	5,639
2008	0,269	3,64	0,385	3,75	0,376	3,673
	0,396	5,356	0,566	5,518	0,553	5,404
	0,425	5,753	0,608	5,926	0,594	5,804
2009	0,288	3,64	0,385	3,75	0,376	3,673
	0,402	5,075	0,536	5,228	0,524	5,120
	0,444	5,611	0,593	5,781	0,580	5,661
2010	0,287	3,64	0,385	3,75	0,376	3,673
	0,381	4,828	0,510	4,973	0,499	4,871
	0,438	5,555	0,587	5,723	0,574	5,604
2011	0,276	3,64	0,385	3,75	0,376	3,673
	0,384	5,067	0,535	5,221	0,523	5,113
	0,435	5,742	0,607	5,915	0,593	5,793
2012 (Until August)	0,282	3,64	0,385	3,75	0,376	3,673
	0,362	4,670	0,493	4,811	0,482	4,712
	0,431	5,564	0,588	5,732	0,575	5,614
	-1,85	0,00	0,00	0,00	0,00	0,00
Average rate of change of the currency during 2001-2008	5,37	7,35	7,35	7,35	7,35	7,35
	1,23	3,14	3,14	3,14	3,14	3,14

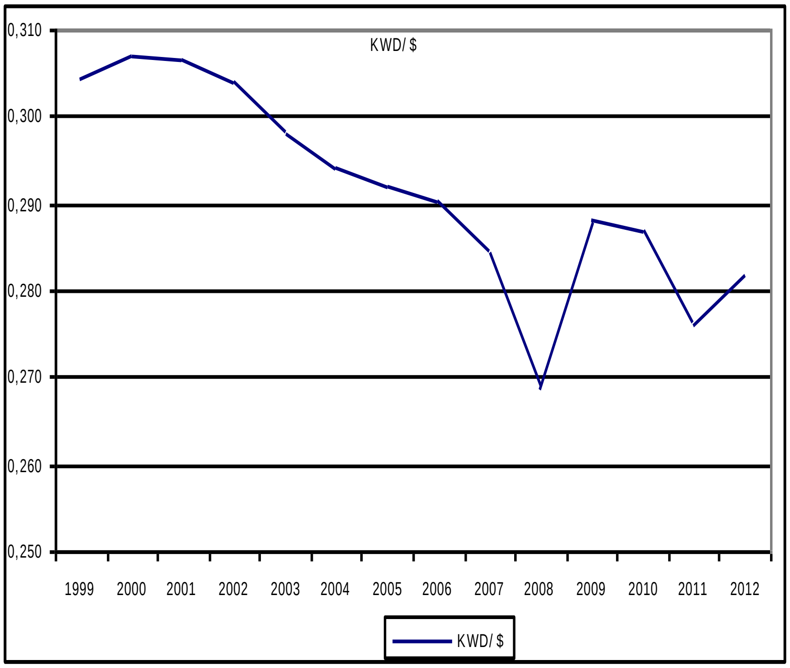
	0,68	0,00	0,00	0,00	0,00	0,00
Average rate of change of the currency during 2009-2012 (%)	-1,27	-1,94	-1,94	-1,94	-1,94	-1,94
	0,20	-0,47	-0,47	-0,47	-0,47	-0,47

* The first number reflects the exchange rates of GCC currencies against the dollar; the second number is for the euro, and then the third number for the SDR.

** Source: calculations by the author based on data of European Central Bank, Central Bank of Kuwait, and Pacific Exchange Rate Service

The depreciation of the dollar during last years against other major currencies like euro, which accelerated in 2008, contributed to highlight the negative impact to link the economies of the Gulf in U.S. dollars (graphic. 1). Accordingly, the value of GCC currencies may fell against the euro by 7.35% during 2001-2008 excepted of Kuwait which ended the relationship with the dollar link in 2007, since the depreciation is limited at 5.37%. As for of the movements of exchange rates of GCC currencies against the SDR, recorded except Kuwait a decline estimated only at 3.14% (table. 3 and graphic. 2). The appreciation of the dollar from 2009 leads to a substantial increase in the value of Gulf currencies, although with different rhythms since the Kuwaiti dinar recorded a lower rate of 1.27% compared to a value of 1.94% for the other countries.

<u>Graphic. 2:</u> Exchange rate, KWD/ US dollar 1999-2012



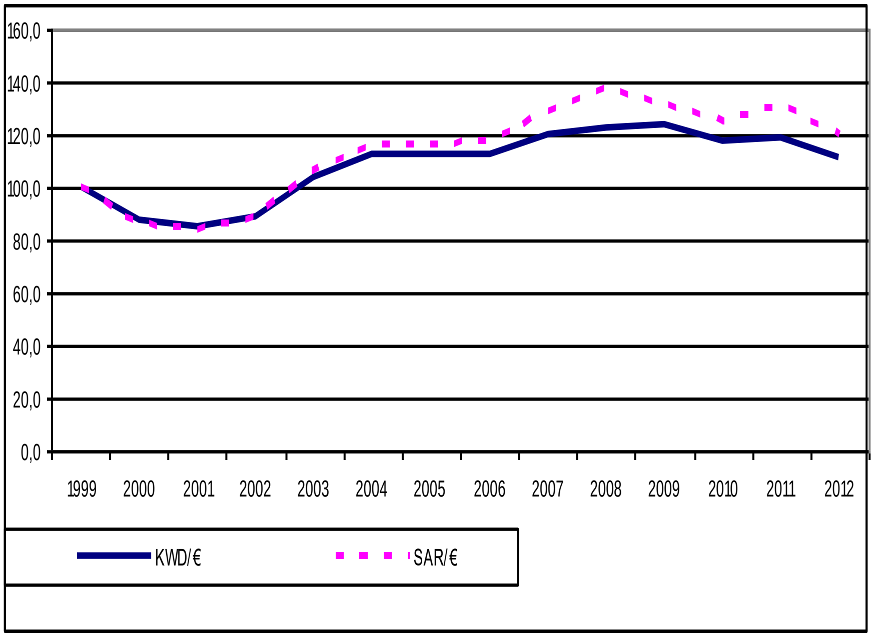
Source: Graphic made by the author based on data of the Central Bank of Kuwait

Throughout the reference period, the GCC countries have seen, with the exception of Kuwait, a decline in the value of their currencies by about 30% during the period 2003 - 2008, , due to the depreciation of the dollar against the euro, while in Kuwait the dinar has witnessed a decline of its value of 17,5% after the decision of authorities to determine the exchange rate against a basket of currencies as from the second quarter of 2007, which led to a rise in the value of the dinar against the dollar by about 12.5% during the same period.

This lets say that for the Gulf States, thought to have benefited from rising oil prices during past years, these increases were in part only a loss. In fact, the dollar (currency of regulation of the oil) lost more than quarter of its value during the same period which witnessed escalating price. In other meaning, Gulf economies have not achieved all the gains of high oil prices that went due to lower prices of the dollar, therefore the currency to be adopted to link their currencies must have solid economic fundamentals, a strong fiscal policy, and a sable monetary policy leading to reduced rates of inflation.

<u>Graphic. 3:</u> Exchange rate index, KWD/€ and SAR/€

1999-2012, base 100 = 1999



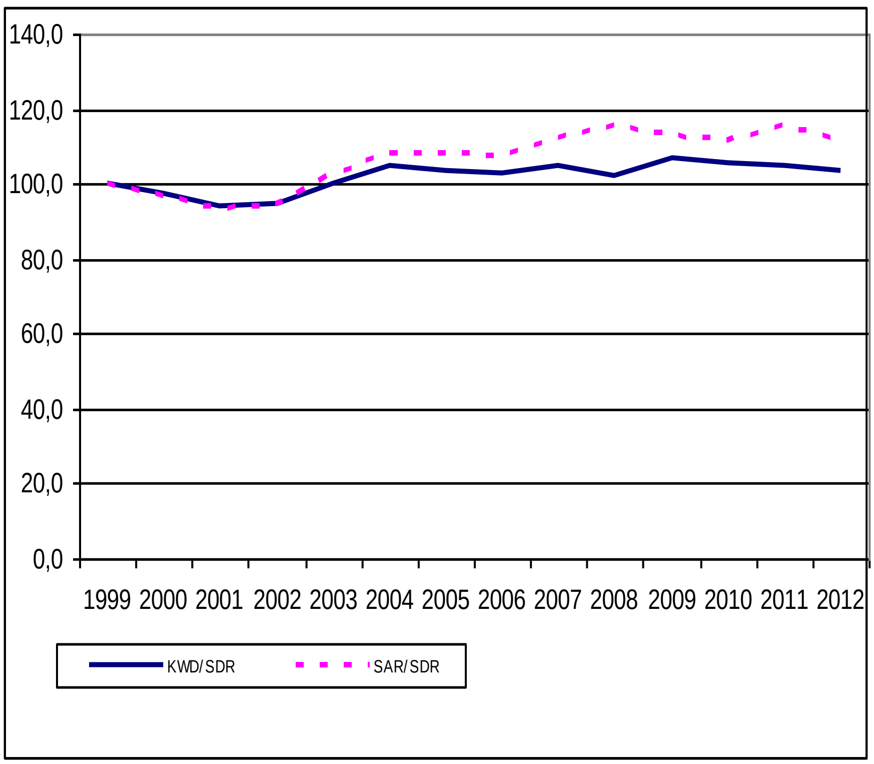
Source: Graphic made by the author based on data of the Central Bank of Kuwait, and European Central Bank

This result is reinforced by the General Secretariat of the Federation of Chambers of GCC economic report recently published about quarterly performance economies of the GCC, which mentioned that the economic policies followed by governments over the past years to pursue policies aimed at promoting economic growth, has been helped by high oil prices which allowed the registration of a large financial surplus even under the increased spending. However, the strategy of the rapid growth in some countries contributed in creating great inflationary pressures compounded by the link of the region's currencies to the dollar by a fixed price. However, it is making continuous efforts to address the structural problems, such as the labour market and strong support for commodity prices and inefficient governance standards in corporate management, but those problems persist.

Furthermore, the divergence in the evolution of the exchange rate respectively of the Kuwaiti dinar and other currencies of Gulf countries compared to Euro and SDR reached its major phase in 2008 after the disengagement of the dinar from the dollar. In this framework, as illustrated in graphics 3 and 4, we emphasize the relative stability in the trend of the dinar against other Golf currencies. This supports the idea of the superiority of the peg to a basket of currencies better than one currency, given the consequences suffered following any negative evolution of the exchange rate of this currency for reasons often explained by the country's internal situation of currency of peg.

Graphic. 4: Exchange rate index, KWD/SDR and SAR/SDR

1999-2012, base 100 = 1999



Source: Graphic made by the author based on data of the Central Bank of Kuwait, and Pacific Exchange Rate Service

Conclusion

In order to stimulate trade and ensure more integrated economies, GCC countries decided to create a monetary union which allows a single currency; felt that it is better to rely on a single monetary policy based on the convergence criteria. It was hoped that the unified currency will be adopted by 2010, but it has not yet achieved. The Euro zone crisis may have shown that the single currency can create serious problems undermining confidence in this currency. But, in the same way, the history of attachment to dollar has cost to Golf countries a loss in their oil revenues, as well as a decline in the value of their currencies against major others like the Euro and the SDR. As a solution, we can suggest the link with a basket of currencies which has reduced in the case of Kuwait losses during the period of depreciation of the dollar. It can be a step toward stabilizing the evolution of exchange rates of the currencies, which must precede the establishment of a single currency in the GCC countries.

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