CONFERENCE PROCEEDINGS

THE THIRD ANNUAL CONFERENCE OF ISLAMIC ECONOMICS & ISLAMIC FINANCE

ECO ENA Researches & Policy Analyses

CONFERENCE PROCEEDINGS

THE THIRD ANNUAL CONFERENCE OF ISLAMIC ECONOMICS & ISLAMIC FINANCE

The Third 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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2016

The Third Annual Conference of Islamic Economics & Islamic Finance

Venue: Chestnut Conference Center; Toronto University
Toronto, ON, Canada
October 29th, 2016

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

Conference Participants:

Prof. Rodney Wilson, Durham University, UK & Sharjah University, UAE
Prof. Sheila Htay, Humber College and York University, Toronto, Canada
Dr. Brian A. Zinser, Northern Michigan University, USA
Dr. Trisiladi Supriyanto, Ibnu Khaldun University, Indonesia
Mr. Dean Peloso, York University, Toronto, Canada
Dr. Freyedon Ahmadi, Payame-Noor University, Iran
Mr. Washim Ahmed, Law Office of Roger Rowe, Toronto, Canada
Mr. Akhbar Mohammed, York University, Toronto, Canada
Mr. Imran Noorani, York University, Toronto, Canada
Mr. Syed Ahmed Salman, International University, Malaysia
Mr. Ahmad Popalyar, Zero Mortgage Canada, Toronto, Canada
Dr. Mohamed A. Gouda, King Faisal University, KSA
Dr. Ghada G. Mohamed, FUE, Egypt

Other contributors (Attendees):

Mr. Rami Albustami, Carleton University, Canada
Mr. Fouad Hijazi, Carleton University, Canada
Mr. Usman Mazhar, Bank Islami, Vaughaan, ON, Canada

Other contributors (Couldn't attend the conference):

Mr. Mahfuzul Alam Taifur, University of Malaysia, Malaysia
Mr. Muhammad Rashid, Abu Dhabi University, United Arab Emirates
Mr. Baqir Fateh, University of Arkansas, USA

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The Third Annual Conference of Islamic Economics & Islamic Finance

Venue: Chestnut Conference Center; Toronto University
Toronto, Canada
October 29th, 2016.

Conference Program

8:30 am
Registration and Reception

9:00 – 9:20 am
Opening by **Ghada Mohamed**; Conference Chair

9:20 – 10:00 am
"Islamic Home Financing in Canada"
Sheila Htay, Humber College and York University, Toronto, Canada

10:00 – 10:40 am
"Keynote Speech on Islamic Banks"
Rodney Wilson, Durham University, UK & Sharjah University, UAE (*Over Skype*)

10: 40 – 11:00 am
Open Discussions

11:00 – 11:40 am
"***Usage of Islamic Banking and Financial Services by United States Muslims***"
Brian A. Zinser, Northern Michigan University, USA

11:40 – 12:20
"***Rate of Profit as a Price Benchmark in Islamic Banking to Create Financial Stability***"
Trisiladi Supriyanto, Ibnu Khaldun University, Indonesia

12:20 – 12:50
"The Growth of Islamic Financial and Capital Markets"
Dean Peloso, York University, Toronto, Canada

12:50 - 1:00 pm
Open Discussions

1:00 – 2:00 pm
Mediterranean Vegetable Break

2:00 – 2:40
"***Designing and formulating action plan for development of corporate citizenship in producing units in Iran***"
Freyedon Ahmadi, Payame-Noor University, Iran

2:40 – 3:20
"Concept of Property (Al-Mal) – Sharia V Common Law"
Washim Ahmed, BA, LLB/JD, LLM Barrister & Solicitor Law Office of Roger Rowe, Toronto, Canada

3:20 – 3:30
Open Discussions

3:30 – 4:00
"***Convergence between Islamic Venture Capital and Social Venture Capital***"
Akhbar Mohammed, York University, Toronto, Canada

4:00 – 4:30

"***Takaful as a form of Ethical Insurance in Canada***"
Imran Noorani, York University, Toronto, Canada

4:30– 5:00

"***The Need for Shari'ah Compliance Insurance through Takaful***"
Syed Ahmed Salman, International University, Malaysia

5:00– 5:30

Islamic Products in the Canadian Market

Ahmad Popalyar
Zero Mortgage Canada, Toronto, Canada

5:30– 6:00

Islamic Financial Management in the Cradle of Islam
Ghada G. Mohamed & **Mohamed Gouda**
Future University in Egypt & King Faisal University, KSA

6:00: **Closing**

Venue: Chestnut Conference Center; Toronto University
Toronto, Canada
October 29th, 2016.

Selected Papers & Articles

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Usage of Islamic Banking and Financial Services by United States Muslims

Brian A. Zinser
Walker S. Cisler College of Business
Northern Michigan University
Marquette, Michigan

Abstract

There is limited published research on Islamic marketing in the United States. Dinar Standard, a commercial marketing research firm which specializes in the Muslim market released findings from a consumer market research study in 2011, which they updated in 2014/15 which included an estimate of the usage of Islamic banking and financial services by Muslims residing in the U.S. This paper presents some findings from a different investigator from data collected in late 2014 which provides evidence that the usage rate of these products and services may be much higher than estimated by DinarStandard. The evidence is based on a nationwide representative sample (n=251) of individuals between 18 and 54 who reside in the U.S. and self-identify as Muslims. The sample was obtain using a *Qualtrics* online panel. In addition, the paper provides insight into the most popular Islamic banking and financial service products that U.S. Muslims have had experience with or use. Providers of banking and financial services in the U.S. should find the information useful in determining the attractiveness of segmenting and targeting the American Muslim market and developing *Shariah* compliant products and services to meet the segment's needs.

Keywords—American, Banking, Financial Services, Islamic, Muslims, United States

Arabs used interest-free financing in commerce and trade long before the prophet Muhammad, himself a trader, started receiving revelations that he believed to be from God. These revelations were recorded in the *Qur'an*, or Islam's holy book.

Shariah law governs financial services for devoted Muslims. According to *Shariah* law, contracts or arrangements involving the payment or receipt of interest are forbidden. Payment or receipt of interest violates the *Shariah* concept of *riba. Riba* essentially means excessive gain or usury (Saeed, 1999). This practice was also condemned in early Judeo-Christian lending (Bennett, 2007; ElBoghdady, 2006). Furthermore, personal financial guarantees are problematic in Islamic culture. As a result, traditional deposit and loan financial services products in the West which are priced primarily through the exchange of interest and, in some cases, are unsecured (personal notes and credit cards), are problematic for Muslim consumers (Cocheo, 2007).

Many investment products like common stocks, bonds, and mutual funds pose problems for Muslims as well (Ayub, 2008; Usmani, 2002). *Shariah* law bars Muslims from investing in businesses that are deemed repugnant such as alcoholic beverages, gambling, pork processing, or pornography. It also prohibits investing either directly or indirectly in interest-bearing instruments or bonds.

The current rise in the popularity of *Shariah*-compliant financial services worldwide began simultaneously with the modern rise of the Islamic world in the late 1960s (Bennett, 2007; Chong & Liu, 2009). The independence of Muslim nations coupled with enormous accumulation of oil wealth initially led to the creation of *Shariah*- compliant commercial financial services. More recently, the growing Muslim middle class has also demanded *Shariah*-compliant retail financial services products. These products include arrangements for financing home purchases and expensive consumer durables which do not involve *riba* or personal guarantees, and personal investments like mutual funds in which the portfolio includes companies which market alcoholic beverages, pork products, or operate gaming businesses.

There are many critics, including academics and conservative Islamic scholars (Bennett, 2007; Chong & Liu, 2009; Khan, 2010), who claim that Islamic banks and conventional banks with Islamic windows have developed mortgage or secured loan-like and deposit-like products that are nothing more than interest-bearing activities in disguise. Timur Kuran of Duke University's Islamic studies program was quoted in the *Boston Globe* (Bennett, 2007) as saying these banks have done nothing more than come up with "convoluted ways of lending money that make interest look like something else, when in fact they're really just operating like conventional banks."

Retail Islamic financial services in the United States arose in the mid-1980s with the genesis of what is now known as Amana Funds Goud, 2009). Concurrently, American Finance House-LARIBA (LARIBA) of Pasadena, California began offering *Shariah*-compliant small business and home financing. Goud (2009) noted that a major breakthrough for retail Islamic financial services occurred in 2001, when LARIBA received approval for financing from the Federal Home Loan Mortgage Corporation. As the Muslim market segment became more attractive, Goud noted that new entrants began to enter the home finance market including HSBC Amanah in New York, Guidance Financial in the nation's capital, Devon Bank in Chicago, and University Bank in Ann Arbor, MI.

Islamic branding and marketing in the United States and specifically the market segmentation and product differentiation strategy of firms marketing *halal* products and *Shariah*-compliant Islamic banking and financial services is in its infancy but increasing in availability (Chiu, Newberger, & Paulson, 2005). *Halal* is an Arabic term which is primarily used to identify lawful or permissible food, but can also be used to identify any lawful or permissible object or action according to Islamic law. DinarStandard (2011, 2015), a New York based specialized market research and advisory firm which focuses on the Muslim market, released a study on the U.S. Muslim market in 2011 and updated it in 2014/15. The 2011 study reported a majority (81%) of U.S. Muslims comply with Islamic restrictions regarding *halal* food. The 2011 study found that an equal majority of U.S. Muslims do *not* use *Shariah*-compliant Islamic financial services. However, when asked, more than 90% indicated a strong interest in using Islamic financial services. In the updated 2014-2015 study, DinarStandard reported that while a "vast majority of respondents adhered to consuming Halal food (93%), an equally vast number (85%) said they do not use Islamic finance. This sentiment holds for mid-to-high income respondents as well." (DinarStandard, 2015, p. 12)

As a matter of policy, the U.S. Census Bureau does not ask individuals their religion. Estimating the number of Muslims residing in the United States is difficult. Prior to the Pew Research Center's report *Muslim Americans: Middle Class and Mostly Mainstream* (2007), no estimate for the U.S. Muslim population, based on widely accepted social scientific methods, was available. Updated projections in 2011 by Pew Research Center (2011) demographers estimated that there were about 2.75 million Muslims of all ages living in the United States.

Other studies have estimated the number of Muslims in the United States as much higher (Pew, 2007). Based on the Pew study along with other sources of information (e.g., Gallup, Council on American-Islamic Relations, Association of Statisticians of American Religious Bodies, city level surveys), the DinarStandard (2011, 2015) study team estimated that the U.S. Muslim population was between 5.8 million and 6.7 million in 1.7 million to 2 million households. Furthermore, they reported estimates of the annual growth rate at 6% compared to the U.S. population annual growth rate of slightly less than 1%.

Regardless of the U.S. Muslim market's actual size, it is apparent that it is a sizable and growing market and Islamic banking and financial services are arguably transitioning from the introduction phase to the growth phase of its product lifecycle in the United States.

The purpose of this paper is to introduce some recent research findings which provide evidence that suggests that the use of Islamic banking and financial services in the United States is higher than DinarStandard (2011, 2015) found in their studies.

Islamic Banking and Financial Services Use

The rise and popularity of Islamic banking and financial services has drawn a fair amount of attention from marketing academics including several patronage and attitude related studies. A research literature review by Åström (2013) has identified more than 50 customer-related studies since Erol and El-Bdour(1989) published an article on attitudes, behavior, and patronage factors toward Islamic banks in Jordan. An empirical survey on retail customer attitudes toward Islamic financial services was also published by Gait and Worthington (2008) and a critical literature review on Islamic bank selection criteria in Malaysia was completed by Nawi, Yazid, and Mohammed (2013).

The vast majority of the marketing-related studies have been conducted in countries where Muslims are a majority of the population. The first known study to be done in a country where Muslims are a minority was investigated by Omer (1992) in the United Kingdom. Three hundred Muslims were surveyed about their patronage factors and awareness of Islamic financial services. Gerrard and Cunningham (2001) conducted a study comparing Muslims and non-Muslims bank selection criteria in Singapore, a country where Muslims are also a minority. More recently Saini, Bick, and Abdulla (2011) surveyed 250 Muslims residing in South Africa, a country where Muslims are a very small, almost notional minority.

A noticeable gap in the Islamic banking and financial institution marketing-related literature is the absence of any study being conducted in the United States or North America. Furthermore, no known research has been published on the usage of Islamic banking and financial services by U.S. Muslims other than the DinarStandard (2011, 2015) studies introduced in the previous section.

Methodology

Population of Interest and the Sampling Plan

The population of interest for this study was U.S. Muslims who are defined as individuals who identify as being Muslim, e.g., a believer in or follower of Islam, and reside in the United States. The sample for this study was comprised of individuals who met this definition and were between the ages of 18 and 54. This age range selection criterion was selected as these individuals are most likely consumers of or have a need for personal banking and financial services.

The proportion of individuals who meet the definition of a U.S. Muslim within the general population of the United States is very low. Because of the relatively low percentage of

Muslims in the U.S. population, it was determined that traditional sampling strategies would not yield an adequate number of participants. *Qualtrics*, a for-profit external market research service provider who maintains a by-invitation-only panelist database, provided a set of participants who met the definition of the population of interest. The online survey instrument, which was developed using *Qualtrics*' online survey development software and survey distribution system, was then sent out to the selected panelists using email invitations. The comprehensive fee paid to *Qualtrics* was for the list of panelists and incentives for those panelists who participated in the study. An incentive, unknown to the investigator, was paid by *Qualtrics* to each participant who completed the survey in the form of points, which then can be redeemed to purchase consumer products.

Among the advantages of using the online panel was the sample contained participants across the United States and from a variety of ethnic backgrounds (e.g., Arabs, South Asians, African Americans, etc.). Therefore, the results of this study are more applicable to the general U.S. Muslim population. Two hundred fifty-one valid surveys were obtained.

Questionnaire Development

A questionnaire was developed to captured usage of Islamic banking and financial services, demographic information as well as other variables used in the author's research program. A short description of the term "Islamic banking and financial services" was provided to ensure that all respondents had a common understanding of how the term was used in the questionnaire.

Experience using Islamic banking and financial Services. Items assessing previous experiences with Islamic banking and financial services were developed by the investigator. Respondents were asked to indicate whether they had ever used Islamic banking and financial services products. If a respondent indicated that they had used these services, they were asked to specify the Islamic banking and financial services products that they had purchased and or were currently using.

Respondents were provided the following product choices and definitions in the questionnaire:

murabaha (Home financing product similar to an installment sale.)
musharaka (Home financing product similar to a co-partnership.)
ijara (Home financing product similar to rent to own.)
sukuk (Investment product similar to a bond.)
takaful (Similar to an insurance policy.)
Shariah compliant mutual funds

Demographic Information. Respondents' information was obtained from nine demographic items including questions about age, gender, marital status, race, citizenship status, education level, annual household income, and geographical location.

Web Questionnaire Pretest

The online version of the questionnaire was pretested with members and friends of the Muslim Student Association (MSA) of a medium-sized technological university and members of an Islamic mosque/center in the Upper Midwest. A donation of $5 to each organization was offered as an incentive for each completed questionnaire. After each measurement question in the survey, pretest respondents were asked the following open-ended question: "If you did not understand the question above, please explain why?" Twenty-six complete surveys were received from the MSA list while nine complete surveys were received from the Islamic center. The results of the pretest survey were analyzed for clarity of instructions embedded in the questionnaire, the wording of questions, and the structure of the questionnaire. Comments received from the open ended questions were also reviewed. Based upon the analysis and feedback received, some minor modifications were made to a few questions primarily to clarify participants' understanding of the intent of the question's syntax.

Findings

The revised survey was provided to *Qualtrics*, which also provides panel services for a fee. In order for *Qualtrics* to manage the panel and to improve the validity of the responses, the panel managers added three screener questions and two attention trap questions. The screener questions were added to the beginning of the survey prior to the consent section to insure that respondents fit the sampling frame. The first screener question asked if the prospective participant identified as being of the Muslim faith. It was followed by a question confirming the prospective participant resided in the United States. Finally, prospective participants were asked if they were between 18 and 54 years old.

Since the sample data were being drawn from panel members who were paid an incentive based on completed surveys, two attention trap questions were inserted into the measurement item section of the survey to catch "speeders and cheaters"; respondents who just click through without actually looking at the content of the survey (Smith & Albaum, 2013). Skip logic terminated any participants immediately after they answered a screener question incorrectly, declined the consent form, or did not answer or answered an attention trap question incorrectly. The pretest panel study was conducted and data was collected during late 2014.

Table 1 provides a summary of the flow of the elimination of participants by *Quatrics'* panel management team in order to provide the contracted sample size of 250 respondents.
Table 1

Flow of Participants through each Stage of Elimination in Qualtrics' Panel Management

Total individuals contacted by *Qualtrics*	426	
Less those who did not identify as being Muslim	26	6.1 %
Less those who did not reside in the United States	7	1.6 %
Less those who were not between 18 and 54 years old	5	1.2%
Less those who did not consent	16	3.8%
Less those who did not answer or answered first attention trap question incorrectly.	96	22.5%
Less those who did not answer or answered second attention trap question incorrectly.	25	5.9%
Final Sample	n =251	58.9%

A validation and editing review of the final sample questionnaires was performed to assure that the online data collection process including skip logic and data validation performed as expected. All completed surveys which made it through each stage of the participant elimination procedure in Table 1 above were complete with the exception of one completed survey which was missing one demographic variable.

Even though two "attention trap" questions were asked by *Qualtrics* during the management of the panel, the sample provided was checked to identify any unengaged responses which may have made it into the final sample. The standard deviation of all measurement item variables for each case was computed and those rows with standard deviations less than .5 were examined. Three cases had standard deviations below .5. Only one of the three cases was eliminated as it had a standard deviation of 0 and thus no variation in responses. The remaining two cases appeared to have some variation in answers across items and were retained in the sample. Since the measurement item questions were randomized during the administration of the online survey, detecting patterned responses by visually examining each case was not a feasible additional procedure for detecting unengaged responses.

Table 2 shows the number and percent of respondents by gender, marital status, age category, U.S. citizenship status, race, household income, highest level of education, and state of residency. The sample was fairly evenly split between genders. As expected, a very small percentage indicated being divorced or separated. There was dispersion of participants across all three age categories with the highest percentage being 18-29 years old. Almost all participants indicated being either a U.S. citizen or a permanent resident. Nearly half identified as being white while a quarter identified as Asian. Black and other/mixed almost evenly comprised the remaining quarter with just four individuals identifying as Hispanic. Respondents' reported annual household income was evenly distributed across all five categories. More than half of respondents indicated being a college graduate.

Thirty-eight states were represented in the sample with the highest number of respondents coming from states with high Muslim populations: California followed by, in descending order, Florida, Texas, New York, Michigan, Illinois, New Jersey, Indiana, Georgia, and Pennsylvania.

In addition to demographic information, participants were asked whether they have or are currently using Islamic banking and financial services. Forty-seven percent or 119 of total respondents indicated having experience with or use of Islamic banking and financial services. Based on the sample size (n=251) and making the assumption that the sample was "random," the margin of error for the study is plus or minus 6.19%. These results provide evidence that usage of these products and services is much higher than the DinarStandard (2011, 2015) studies which reported experience or use of Islamic banking and financial services by about 15 - 20 percent of the U.S. Muslim population. Based upon the distributions of the demographic variables in Table 2, the investigator has no reason to believe that the sample obtained is not representative of the U.S. Muslim population.

Table 2

Sample Demographic Analysis

Variable	N	Percentage
Gender		
Male	120	47.8
Female	131	52.2
Marital Status		
Married	176	70.1
Divorced	5	2.0
Separated	3	1.2
Never Married	66	26.3
Age Category		
18-29 years old	109	43.4
30-39 years old	99	39.4
40-54 years old	43	17.1
Citizenship Status		
U.S. Citizen	191	76.1
U.S. Permanent Resident	53	21.2
Other	7	2.8
Race		
White	116	46.2
Black	33	13.1
Hispanic	4	1.6
Asian	66	26.3
Other/mixed	32	12.7
Household Income		
Less than $30,000	49	19.5
$30,000 - $49,999	45	17.9
$50,000 - $74,999	96	38.2
$75,000 - $99,999	31	12.4
Greater than $100,000	30	12.0
Highest Level of Education		
Graduate Study	41	16.3
College Graduate	112	44.6
Some College	70	27.9
High School Graduate	25	10
Not a High School Graduate	3	1.2

Finally, if one indicated experience or use of Islamic banking and financial services, they were further asked to select which products and services they had or have used. Table 3 summarizes the responses. The most commonly reported product or service was home financing instruments; *Murabaha*, *Musharaka*, and *Ijara* in descending order.

Table 3
Most Popular Islamic Banking and Financial Services

Islamic Banking and Financial Service	Responses	Incident % of Respondents
Murabaha	65	54.6
Musharaka	48	40.3
Ijara	43	36.1
Sukuk	31	26.1
Takaful	32	26.9
Mutual Funds	32	26.9
Other	4	3.4

Conclusion

A limitation of this study, was the sample obtained. Because of the difficulties of obtaining a random sample, a convenience online sample was obtained from individuals who were part of a panel service provided by a for-profit company. Caution should be used in projecting the results of the sample to the general population of U.S. Muslims. There may have been response as well as other biases in the sample.

Providers of conventional banking and financial services in the United States who are thinking of developing and marketing Islamic products can use the results to assess the attractiveness of the Muslim market. The results can also be used by existing Islamic bank and financial services providers to develop a more effective integrated marketing communications strategy.

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RATE OF PROFIT AS A PRICING BENCHMARK IN ISLAMIC BANKING TO CREATE FINANCIAL STABILITY

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Abstract:

Although much research has been done on the pricing benchmark both in terms of fiqh or Islamic economic perspective, but no substitution in the concept of interest (rate of interest) up to now in the application of Islamic Banking because some of the jurists from the middle east even allow the use of a benchmark rate such as LIBOR (London Interbank Offered Rate) as a measure of Islamic financial asset prices, so in other words, they equate the concept of rate of interest with the concept of rate of profit, which is the core reason (raison detre) for the replacement of usury as instructed in the Qu'ran. This study aims to find the concept of rate of profit on Islamic banking that can create economic justice and stability in Islamic Banking and Capital market. Rate of profit that creates economic justice and stability can be achieved through its role in maintaining the stability of the financial system in which there is an equitable distribution of income and wealth. To determine the role of the rate of profit as the basis of the sharing system implemented in the Islamic financial system, we can see the connection of rate of profit in creating financial stability, especially in the asset-liability management of financial institutions that generate a stable Net Profit Margin or the rate of profit that is not affected by the ups and downs of the market risk factors including indirect effect on interest rates. Furthermore, Islamic financial stability can be seen from the role of the rate of profit on the stability of the Islamic financial assets that are measured from the Islamic financial asset price volatility in Islamic Bond Market in Capital Market.

Keywords: *rate of profit, economic justice, stability, equitable distribution of income, equitable distribution of wealth.*

1. THE BACKGROUND

As a consequence of the abolition of interest, Islamic financial system requires a replacement and applicative concepts of interest at the operational level in the Islamic Financial Institutions which is in accordance with Islamic principles. Applicative concepts as a substitution of interest, in the Qur'an mentioned as profits that derived from the commercial transaction without any exploitation, while in the economic literature of Islam, among others referred to as the (expected) rate of profit)[1] or (required) rate of profit. Some classical economists call it as the rate of profit like Von Neumann and Pierro Sraffa. From the neo-classical economist Henry Thornton refer the concept as a marginal rate of profit[2], while Knutt Wicksell called the concept as a natural rate of profit[3]. In the concept of thoughts itself, there are disagreement among both Conventional and Islamic economist. At the level of application of the concept of rate of profit as a substitution of interest concept is very important, given the policy management of Islamic financial system today in some countries, both at the macro and micro levels still do not have a clear concept.

At the macro level, the application of the rate of profit concept for example can be seen in central bank policy in countries that have implemented Islamic economic system either the dual banking system or Full Islamic economic system (single economic system). Amongst both systems the application in the financial system is different. The central banks are found to have used different transactions in implementing an instrument of monetary control. In the practice of the Islamic financial system, there is a difference of opinion in the use of contracts in the instrument of monetary operations, i.e. the countries with monetary instruments which use the rate of profit that is post determined (ex post) and the countries that use the monetary instruments with the rate of profit that is predetermined (ex-ante). Countries that implement monetary instruments with a rate of profit that is post determined (ex-post) are Sudan, Iran and Pakistan with the contract of Musharakah and Mudharabah, while the countries that implement monetary instruments with the predetermined rate of profit (ex-ante) is Malaysia and Indonesia, namely the contract

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[1] M.A. Choudhury, *Generalized Theory of Islamic Development Financing* (London: The Edwin Mellen Press, 1997), 47.

[2] Henry Thornton, *An Inquiry Into the Nature and Effects of the Paper Credit of Great Britain*, edited by F.R. von Hayek. (New York : Rinehart, 1965), 35.

[3] Wicksell, *Lectures in Political Economy*, trans. E. Classen (London : Routledge, 1934), 148.

of Bay 'al-'inah, Murabahah[4] and Ju'alah. According to the authors, the differences in the use of monetary instruments are due to the differing views on the effectiveness of monetary policy to regulate the money supply. Instruments with a predetermined rate of profit are considered more effective in attracting money in circulation.

At the micro level, the application of the rate of profit concept is often facing a problem because there is no yardstick (benchmark) in determining the profit margin on natural certainty contracts such as the Sale-based contract like Murabahah and the Leasing Based contract like Ijarah in Islamic banking practices in some Islamic countries. Furthermore there is a difference in the application of the rate of profit, especially on a sale based contract i.e. Murabahah. Some Muslim countries apply the rate of profit in Murabahah (called as a margin or mark-up in some countries) and Ijarah (called as ujrah or coupon in sharia bond transaction) which are quoted fixed for long term financing transaction. In Pakistan, Murabahah with a fixed rate of profit can be used both in the short term, medium and long term. In Bangladesh, the contract of Murabahah is used for short-term transactions while the Bay 'muajjal with installments is used for the purchase of long term assets. In the UK, the contract of Murabahah even used in home financing transaction with a very long period of 20-25 years.

The Application of the concept of rate of profit[5] as a replacement of the rate of interest concept (interest rates) in the banking and capital markets (bond) sharia system is often facing a problem in the field because there is no yardstick (benchmark) in determining the profit margin on the contract of sale like *Murabaha* and the leasing costs on the contract of leasing like *Ijara* in Islamic banking transactions or on Islamic bonds transactions[6]. As a result, the entire applications of riba in Islamic financial institutions like the 4-type of interest rate formula i.e. simple interest , compounded interest , fixed interest, variable interest which are all determined in advance (predetermined), are all applied in Islamic Banking Products especially trade and leasing based financing like *Murabaha* and *Ijara*.[7]

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[4] Saiful Azhar Rosly, *Islamic Interbank Money Market: Critical Issues on Islamic Banking and Financial Markets*, 595-601 dan Mohd Azmi Omar, Muhammad Abduh dan Raditya Sukmana, *Fundamentals of Islamic Money and Capital Markets*, 60.

[5] See M.A. Choudury, *Generalized Theory of Islamic Development Financing* (London: The Edwin Mellen Press, 1997), 47.

[6] Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics and Practice* (New York: Cambridge University Press, 2006), 77.

[7] Abdullah Sa'eed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (Leiden: E.J. Brill, 1996), 43.

Among the critical issues that emphasized in the debate over the concept of rate of profit as a replacement of rate of interest concept is that whether Islamic financial institutions has incorporated elements of *'iwadh* (counter value for a benefit of the good or service) or they just do the *ziyadah* (profit creation in the absence of activity in the real sector) in the determination of its rate of profit. According to the theory of Islamic rate of profit, to take a legal profit a product must contain three elements, namely: 1) the value added or value addition in a product as a result of the element of work (*kasb*), 2) risk-taking (*ghurm*) due to the risk of price changes on goods that is traded and 3) underwriting liability in case there is a defects in goods sold (*dhaman*).[8]

Nowadays Islamic banks in the financial center around the world are still using the LIBOR (London Inter-Bank Offered Rates) which is the average lending rates of the largest banks in London as a benchmark in quoting rate of profit to their products. The use of LIBOR as a benchmark is practiced in the determination of profit margin (rate of profit) of *Murabaha* or *Ijara* for home financing, leasing and other commercial financing such as financing of cars, motorcycles and other consumer goods as well as pricing Sukuk Al-*Ijara* (Islamic Bond). In Indonesia, Islamic banking is still using SBI (Indonesia Central Bank Certificate) or JIBOR (Jakarta Interbank Offered Rate) i.e. interest rate average of the largest banks in Indonesia, in determining the Islamic financing price such as mortgages, multipurpose loan and other financing as well as in determining the *ujrah* (leasing cost) on Sukuk al-*Ijara* in the Capital Market. The use of LIBOR or JIBOR is essentially the interest rate charged by the 5 (five) largest banks in the world financial centers such as London and Jakarta, which is basically the loan transactions between banks in the money market (not profit from real market), and this rate is determined by the forces of supply and demand for money (money supply and demand) as the cost of funds and is not based on the price of rent or (rate of) profit in the market for goods and services.

The use of LIBOR as a benchmark has raised pros and cons among Muslim economists. Mahmoud A. El-Gamal supports the conventional use of LIBOR as a benchmark or mark up on Islamic Sale Based Product like *Murabaha*.[9] According to the Professor of Economics and Statistics and Head of Islamic Economics, Finance and Management Study at Rice University's, the use of "Islamic Benchmark" unnecessary, impractical and dangerous because even though he acknowledges that the implicit rate (rate

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[8] Saiful Azhar Rosly, *Islamic Interbank Money Market: Critical Issues on Islamic Banking and Financial Markets,* 595-601.

[9] Mahmoud A. El-Gamal is a professor and Head of Islamic Economics, Finance and Management Study, Department of Economics at Rice University, Houston. See http:// www.ruf.rice.edu/~elgamal/files /newvita. pdf

actually charged) in Islamic financial product differ with the rate of interest in nature, depending on the quality of the underlying asset, but Islamic benchmark in the Islamic financial market is not deep enough and did not have a good liquidity to form a uniform rate implicit (uniform) as a benchmark transaction.[10] The differences amongst Islamic Economist in the opinion regarding the use of LIBOR, whether it can be used as a benchmark in Islamic financial market in general, can be rooted from the use of LIBOR as a benchmark in the mark-up of sale based product. They argue that LIBOR as a benchmark is treated only as a point of reference (a reference point) to the cost of capital in the Islamic financial market which is currently co-exist with the conventional financial market which is globally using The Time Value of Money Concept. This is in contrast with other Islamic Economists opinions that prefer to use The Economic Value of Time Concept, which refers to the profit in real sector.

The concept of rate of profit as a substitute for the concept of rate of interest is very important in Islamic Finance Theory, because it plays a very central role in assessing the price of any financial assets. In conventional finance, financial asset prices, especially bond (including sharia bond) is largely determined by the rise and fall of interest rates. If interest rates rise, the prices of financial assets with fixed interest (fixed coupon rate) will automatically fall, because the value of the present value or the current price of the assets are valued based on the discounted value of the cash flow of money to come, whereby interest rates is used as a measurement. So in essence, the rate of profit or margin on the sale based transactions such as *Murabaha* and the leasing cost (ujrah) in *Ijara* transactions basically follow the prevailing interest rate at the conventional banks.

Malaysia and some other countries are using the LIBOR (London Interbank Offered Rate) as a reference in leasing –based product like *Ijara* or leasing, while in Indonesia, based on the research by the author, Permata Bank Syariah uses SBI plus in Indonesia Rupiah *Ijara* Transaction and SIBOR (Singapore Interbank Offered Rate) plus in US Dollar *Ijara* Transactions. Therefore, it is now very urgent to have a standard on Islamic Benchmark separated from conventional banks considering Islamic economics has different characteristics from conventional economy, especially in terms of determining the rate of profit as compared to rate of interest. Basically the concept of rate of profit is the concept of ex post (post determined-cash basis), while the interest is basically the concept of ex-ante or predetermined (accrual basis).

The determination of the rate of profit in the Islamic financial products and Islamic bonds is the key to create economic justice and stability in investment income and welfare of the community. The

[10] Mahmoud A. El-Gamal. *Islamic Finance: Law, Economics, and Practice*, 79.

justice issue can be seen in the form of a just (considerably low) business costs especially for the lower segment like micro entrepreneur when compared to using a system of interest (rate of interest). In the stability issue, unlike conventional banking system which is uses interest rate, the rate of profit which will be used by Islamic Banks and Capital Markets (Bonds) should be guided by the rate of profit or gain in the real sector. In this paper, the author will focus on the rate of profit concept that can create stability in the financial system.

The big question that arises on the formulation of the problem in this research is: "How to realize the concept of rate of profit in the banking and capital markets (bonds) sharia that can create economic stability". To answer the questions above then the question that follows is: 1) How is the role of the rate of profit in creating an equitable distribution of income measured by the Net Profit Margin of the bank's asset liability management; 2) How is the role of the rate of profit in creating an equitable distribution of wealth which is measured by the volatility of financial assets such as sharia Islamic bonds (*sukuk*) in the Islamic capital market.

1.1. The Previous Study on The Rate of Profit Stability of Islamic Bank

1.1.1 Abdel Hamid M. Bashir from Department of Economy Grambling State University conducted a study of the Determinants of Probability and Rate of Return Margins in Islamic Banking ; Some Evidence From Middle East (2000)[11]

The study used banks data in the Middle East in 1993-1998 using almost all of the dependent variable ratios to measure profitability (ROA, ROE, Net Profit Margin (NM) and Profit Before Tax) and the exogenous variables that include BVE, the ratio of loan to asset ratio of non-interest earning assets to assets, the ratio of short-term funds to assets, overhead costs to assets and liability, is also equipped with a variable derived from macroeconomic indicators, such as inflation, real GDP per capita and growth in real per annum plus indicators of tax and financial structure. The results of the study as a whole is: there are influences on the ratio of short-term funds, non-earning assets and operating costs, as well as capital adequacy and financing ratios, but the research did not include the factor of balance sheet structure (Rate Sensitive Asset-RSA/Rate Sensitive Liabilities-RSL) and did not analyze simultaneously to see the joint effect of all the factors to the profitability of Islamic banks in the countries of the Middle East from the

[11] Bashir, A.H.M. *Determinant of Probability and Rate of Return Margins in Islamic Bankings : Some Evidance from Middle East.* (Grambling State University,2000)

research sample. The research using descriptive research method and associative approach with contingency coefficient correlation techniques, and the research results can be concluded that:

a. The Profitability of Islamic Bank in the Middle East countries significantly affected by the capital adequacy and funding ratios significantly and positively, this shows that this research is consistent with the previous research. This shows that the capital adequacy ratio (CAR) plays an important role on the performance of Islamic banks in the Middle East and that is why CAR should be considered as a dependent variable on this research.

b. The Variable of short-term third-party funds (the structure of the liabilities), non-earning asset, and overhead costs jointly influenced on the performance of Islamic banks' profitability significantly.

c. The Factors of foreign ownership significantly affect profitability, with foreign ownership in the bank is pushing management to operational procedures well and apply the precautionary principle, especially for The Islamic banks that are located in countries with income levels are still low.

1.1.2. Martin Cihak and Heiko Hesse from International Monetary Fund (IMF) on the Profit Stability of Islamic Banks in 77 Countries (2008)[12]

The Study with similar results conducted by Martin Cihak and Heiko Hesse which measures the stability at 77 Islamic banks in Bahrain, Bangladesh, Brunei, Egypt, Gambia, Indonesia, Iran, Jordan, Kuwait, Lebanon, Malaysia, Mauritania, Pakistan, Qatar, Saudi Arabia, Sudan, Tunisia, United Arab Emirates, West Bank and Gaza, and Yemen and as a comparison was 397 Conventional Bank in the period from 1993 to 2004 by using a z-score to measure the stability of each bank. A z-score is a measurement of probability value of the bank's assets to be down because of the rising value of liabilities. Z-score can be formulated as a comparison of $(k + \mu) / \alpha$ where k is the capital and reserves as a percentage of assets; μ is the average profit as a percentage of assets and α is the standard deviation of return on assets as a proxy of the volatility of returns. The results from the research concluded that large Islamic banks tend to be more volatile when compared with conventional large bank, which is calculated from the z-score. One explanation is that large Islamic banks are more difficult to adjust to the changes in the risk profile of its assets. In the studies, it were not explained clearly why the causes of the instability of the studied Islamic banks. According to the authors, the difficulty of the change was particularly difficult to change the

[12] Martin Cihak and Heiko Hesse, *Islamic Banks and Financial Stability: An Empirical Analysis* (Kuala Lumpur : International Monetary Fund Working Paper, 2008), 1-26.

structure of assets and liabilities (RSA/RSL) most of which have a rate of profit that is permanent in long-term, that causing a decrease in the parameter profit of μ due to the changes in the market variables (interest rate) that affects indirectly the liabilities in the form of increased demand deposits yield of *mudharabah*. That is why in this research author included the factors of the structure of the assets and liabilities (RSA/RSL) and interest rate as a dependent variables to support the hypothesis on the effect of balance sheet structure of Islamic contract and interest rate (benchmark that Islamic Bank currently use) on its profitability.

1.1.3. Amine Abi Aad dan Elias Raad from Lebanese American University on the Profit Efficiency of Islamic Bank as Compare to Commercial Bank in the Middle East (2009) [13]

Amine Abi Aad and Elias Raad studied between the years 2003-2007, especially in the countries of the Middle East, namely in Bahrain, Jordan, Kuwait, Lebanon, Qatar, Saudi Arabia, Syria, United Arab Emirates and Yemen to the conventional 83 banks and 20 Islamic banks are the mean average net profit in Islamic Bank is lower by 3% compared with the net interest margin at conventional banks which approximately 6 %. According to the author, this happens because between the 2003-2007 period there was an increase in interest rates in general, so that under consideration that many assets transactions are done with *Murabahah* scheme (very long term transaction for 10-20 years) in the Middle East has caused the Islamic banks in these countries could not increase its revenue in a rising interest rate environment, which can be seen from lower AROA (average return on assets) or the average return of income of the assets of Islamic banks in these countries compared to conventional banks. Amine Abi Aad and Elias Raad researched between the years 2003-2007, especially in the countries of the Middle East, namely in Bahrain, Jordan, Kuwait, Lebanon, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Yemen to the conventional 83 banks and 20 Islamic banks are the mean average net profit in Islamic Bank is lower by 3% compared with the net interest margin at conventional banks which approximately 6 %. According to the author, this happens because between the 2003-2007 period there was an increase in interest rates in general, so that under many transactions *Murabahah* in the countries of the Middle East has caused Islamic banks in these countries could not increase its revenue, which can be seen from lower AROA (average

[13] Amine Abi Aad dan Elias Raad, *The Battle of Islamic and Commercial Banks: Are Islamic Banks More Cost, Revenue and Profit Efficient than Commercial Banks: an Empirical Comparative Study from the Middle East* (Saarbrucken, Deutschland: Lebanese American University, 2009), 26-50.

return on assets) or the average return of income of the assets of Islamic banks in these countries compared to the conventional banks.

2. RESEARCH METHODS

2.1. Types of Research and Approach.

Based on the scientific field, this research can be categorized as an Islamic Economic Research where the research associated with the concepts of Islamic economics and then adjusted with the facts or practices in the field of Islamic economics. Based on the data collected approach, this kind of research is qualitative and quantitative research. The qualitative research is a research procedure that produces descriptive data in the form of words, relating to the understanding, meaning and value.[14] In this qualitative study, the author tried to explain the real facts occurred in the field on the application of the concept of rate of profit in Islamic banks both in the macro-economy and micro-economy levels. After that we see how the concept of Islamic economics of the rate of profit in a comprehensive manner, by doing a research study on the Islamic Rate of Profit and the application of rate of profit which has been applied in the previous Islamic financial institutions.[15] Based on the level of achievement, this research can be categorized as a descriptive research and inferential research. Descriptive research is conducted to describe the phenomena that occur in Islamic financial institutions in terms of both macro and micro, in this case the banking and Islamic capital markets. Inferential research is done to find a solution as recommendation that the application rate of profit may bring justice and economic stability (equitable distribution of income) and the prosperity of the society (equitable distribution of wealth), both in the Islamic banking system and capital markets/bonds (Islamic Financial Market).

To complete this research, the author held a study-case quantitative research on the effects of the use of indirect form of interest rate to the rate of profit of Islamic Bank in the period of rising interest-rate from the period of 2004-2009 in Bank Syariah Mandiri (The Biggest Sharia Bank in Indonesia). The purpose of this research is to analyze the concept of rate of profit that is currently used in Islamic Banking practice as a replacement of interest rate concept and its application as well as the influence of the rate of

[14] Kaelan, *Qualitative Methodology in Philosophy* Research (Yogyakarta: Paradigma, 2005), 5.
[15] Muhammad Teguh, *Economic Research Methodology : Theory and Application*, 16-17

profit if we use this benchmark ideally on the distribution of income (net profit) and wealth (asset value) through the investment product and financing transactions in Islamic Bank.

The study aims to prove the hypothesis of a relationship between the variables of the balance sheet structure (Rate Sensitive Asset (RSA)/Rate Sensitive Liabilities (RSL), Interest Rates (Represented by SBI-Central Bank Certificate of Deposit), Financing to Deposit Ratio (FDR), Capital Adequacy Ratio and Non Performing Financing to Net Profit Margin of Islamic Bank represented by the largest Islamic Bank in Indonesia i.e. Bank Syariah Mandiri. Most of these ratios are a key measurement of the health of the banks which is very important and the other variable is SBI as a representation of interest rate as an external factors that is currently used as a benchmark in Islamic Bank Product as discussed earlier and is dominantly affected the pricing of Islamic Bank Product, while Net Profit Margin is a measure of the performance of rate of profit of Islamic Bank.

Among the models for measuring and managing interest rate risk, the repricing gap (RSA/RSL) model is the best known and most widely used[16]. Since currently Islamic Bank used LIBOR or SBI as a benchmark on their product pricing, for instance, Bank Permata Syariah in Indonesia uses SBI + 5 % as a benchmark for their Islamic mortgage financing product, the authors want to know the effect of using interest rate as a benchmark (not the rate of profit of the transaction) on the Net Profit Margin of Islamic Bank which is largely determined by their balance sheet structure (RSA/RSL). A bank's exposure to interest rate derives from the fact that interest-earning asset (RSA) and interest-bearing liabilities show differing sensitivities to changes in market rates. The repricing gap model can be considered an income-based model. The gap is a concise measure of interest risk (or in Islamic Bank case is indirect use of interest rate) that links changes in market interest rate to change in Net Interest Income, in this research Islamic Bank call it Net Profit Margin (NM). Interest rate risk is identified by possible unexpected changes in this variable. The gap (G) over a given time period t (gapping period) is defined as the difference between the amount of RSA (Rate Sensitive Asset) and RSL (Rate Sensitive Liabilities):[17]

$$G_t = RSA_t - RSA_t = \Sigma\, rsa_{t,j} - \Sigma\, rsl_{t,j}$$

[16] Andrea Resti and Andrea Sironi, *Risk management and Shareholders' Value in Banking : From Risk Measurementt Models to Capital Allocation Policies*, (Chicester : John Wiley, 2007), 9-20

[17] Andrea Resti and Andrea Sironi, *Risk management and Shareholders' Value in Banking : From Risk Measurementt Models to Capital Allocation Policies*, (Chicester : John Wiley, 2007), 9

Table 1 report the possible combinations of the effects of interest rate changes on Islamic Bank Profit Margin, depending on whether the gap is positive or negative and the direction of the interest rate change.

Table 1. Gaps (RSA/RSL), Rate Changes and effects on Net Profit Margin on Islamic Bank

Gap	Interest Rate	Net Profit Margin
Zero Gap RSA = RSL	Up	Stable
	Down	Stable
Positive Gap RSA / RSL > 1	Up	Up
	Down	Up
Negative Gap RSA / RSL < 1	Up	Down
	Down	Up

Given the data that currently Islamic Bank on the negative gap condition since the asset are dominantly based on sale based product like *Murabahah* Financing with long term and fixed rate/profit rate while on the liabilities side are dominantly based on variable rate product like *Mudharabah Deposit*, the use of interest rate as a benchmark will harm the Islamic Bank Net Profit Margin. This theory ideally should be proved by the research to look at the effect of using the same benchmark in different nature of transaction in Islamic Banking environment.

From the study of literature, besides allegedly affected by the external factors such as interest rates in conventional banks as mentioned earlier, the Net Profit Margin of Islamic Banking also influenced by internal factors such as the level of Islamic Banks Financing to Deposit Ratio, Non Performing Financing, Balance Sheet Structure or Asset – Liability and CAR[18]. To look at the effect from other factor i.e. the variables of Capital Adequacy Ratio (CAR), Non Performing Financing (NPF) and Financing to Deposit Ratio (FDR) are included at the inception of the research process.

2.2. Data Sources and Data Collection Methods

In this study, the types of data used are primary and secondary data. Primary data is data that is extracted from the main data, in this study because it deals with the concept of rate of profit, the primary data is taken from the literature of Islamic Economics. Secondary data is the data obtained through the processing of the primary data using statistical tools. Sampling is a method used to select and take some

[18] Rivai, V. *Bank and Financial Institution Management Conventional and Sharia System*. (Jakarta : PT Rajagrafindo Persada, 2007), 407

members of the population. From the samples taken, the data can be used as a reference as the characteristics of the population. Data derived from the financial statements of The Bank Syariah Mandiri used as data research. These data have been published by the Bank Syariah Mandiri. The data captured includes financial ratios and Net Profit Margin on a monthly basis within a period of 5 years. The selection of Bank Syariah Mandiri because the bank currently running independently with separate management from the owner, while the other is still a business unit of sharia. On this study, the author used the secondary data retrieved from the data of rate of profit that is called The Net Profit Margin (NM) of Bank Syariah Mandiri (BSM) from year 2004 to 2009 (5 years). The period is selected due to the ideal condition for this research where there is a period of rising interest rates.

2.3 Data Processing and Analysis Methods

The main method of the study analysis is documentary research for qualitative research and combined with quantitative research. The research was done by analyzing data or facts that are logically composed from a variety of data both primary and secondary. Other analytical methods that had been used is a survey method (analytic survey), i.e. the research conducted to draw a conclusions in order to obtain further meaning hidden behind the data. To find the concept of rate of profit that creates economic stability, the author use independent variable i.e. the structure of the balance sheet represented by the RSA/RSL which is specific in Islamic Bank as currently dominated by the product of long term and fixed rate and the use of quantitative research on the effect of interest rate volatility as represented by the SBI (along with other factor) to Net Profit Margin (the rate of profit of Islamic Bank)) in the BSM for 5 years i.e. 2004-2009 is being conducted.

In order to see a model that can be used in this study, based on the nature of the data the author use time series multiple regression model, because in this study there is only one dependent variable and more than one independent variable on the individual object. Statistical test conducted to validate the over-all model, the author used F test (ANOVA). The analysis is used to see how much the influence of the independent variable on the dependent variable. In this study, the independent variables are numeric variables, since the independent variables used in the can from the data of the financial statements of Bank Syariah Mandiri and Bank Indonesia data publication, which is time series data in the period of May 2004 to May 2009, where the interest rate was rising.

The flow process data analysis was done to facilitate the stages of research or analysis of the data, so the research can be more effective and concise. The order of the research conducted as follows:

1. Collect the data of the net profit margin of the bank which is the object of the research, and also collect the data of RSA/RSL, Financing to Deposit Ratio, SBI, CAR and Non Performing Financing (NPF) of Bank Syariah Mandiri
2. The second phase is to test the overall model on this multiple lines regression model by using F-test and R-Square to prove the influence of the independent variables on the dependent variable simultaneously.
3. Finally testing the data to get the model that is BLUE (Best Linear Unbiased Estimator), whereby the author test the data normality with Jarques-Berra test, test the data homoscedasticity with the white heteroscedasticity test, test the autocorrelation with the Durbin-Watson test , test Breusch-Godfrey Serial Correlation LM test and finally test the multi collinearity with VIF test and Condition Index.
4. Having obtained the BLUE model, the third stage is to test F and R-Square to test to the overall independent variables that have been selected and have significant value.
5. Then proceed to test the hypothesis, which is to see the influence of the independent variable partially on the dependent variable by doing the Partial Test or t- test.
6. After the model testing is complete, the best model is found.

3. RESULTS AND DISCUSSION

The concept of rate of profit that can realize the economic stability of the banking and Islamic capital market in this research means the concept of rate of profit that can create economic justice in the distribution of income and wealth. Rate of profit that creates economic stability can be achieved through its role in maintaining the stability of the financial system in which it is realizing the equitable distribution of income and wealth.

The Role rate of profit as the basis of distribution of profit sharing system implemented in the Islamic financial system can be seen in the connection of the rate of profit in creating financial stability, especially in the management of asset-liability of financial institutions like bank resulting in stable Net Profit Margin or rate of profit to be shared out between the customer and financial institutions that are not affected by the ups and downs of the market risk factors, including the indirect effect of the interest rate. Therefore, we need to see: 1) The role of the rate of profit on the stability of the Islamic financial system as measured by the Net Profit Margin on asset-liability management of Islamic banks (to create equitable distribution of income); 2) The role of the rate of profit on the stability of the Islamic financial market as measured by the volatility of the value of Islamic financial assets (to create equitable distribution of wealth); 3) Verification of the empirical results of the concept of rate of profit in Islamic banks, by using quantitative research methods, by analyzing data or facts that are logically arranged from both primary and secondary data.

3.1. Rate of Profit Role in Creating Equitable Distribution of Income Measured from the Net Income Margin of Islamic Bank Asset Liability Management

One of the most important tasks of banks including Islamic banks is to transform the maturities of its assets and liabilities. Almost all banks have assets in the form of financing (loans) and investments in marketable securities, which is funded by liabilities in the form of demand deposits, savings deposits, term deposit and the issuance of securities which has shorter maturity than the asset.[19] The occurrence of this balance sheet structure, we named it the so-called Gap (difference in repricing time period) in the assets and liabilities that will have the implications on the exposure of the rate of profit/net income (or in this research, we called it Net Profit Margin) in the bank as a result on the changes in the market variables including indirect result of interest rate that affect the asset-liability of the bank. For example, the intermediary function of banks offering mortgage financing with a *Murabaha* contract with a mark-up or margin of 14% per year permanently (fixed) for 10 years. To finance this home financing bank offering an investment product in the form of short-term deposits with maturities varying between 1-6 months with an equivalent yield of 7% per year equivalent. Here there is a difference in repricing (gap) between assets that are fixed or, in other words the bank facing a gap risk by a fixed rate in 10 years asset with the liability that will be repriced every 1-6 months. The net result of bank income (Net Profit Margin) or other financial institution (in a conventional bank is referred to a net interest income-NII) at the beginning of the first year thus amounted to 7 percent per annum. If in the second year, there is an increase of interest rates by 1 percent (usually started from SBI rate), this will affect the bank to repriced its liability by 1%, then the bank in the second year have a decreasing Net Profit Margin to 6% per annum. There has been a loss of 1%, as bank is not able to raise the price of the asset- as a result of fixed 10 years asset.

Risk arises in the rate of profit because of the change (indirect) market variables such as indirect effect of interest rates rise in Islamic banks due to the longer-repricing maturity assets than liabilities is

[19] Andrea Resti and Andrea Sironi, *Risk Management and Shareholders' Value in Banking : From Risk Measurement Models to Capital Allocation Policies* (Chicester, West Sussex, England : Jhn Wiley & Sons Ltd), 3.

referred to the risk of refinancing (refinancing risk).[20] As a result of the reverse effect can also occur if the maturity of the asset is shorter than a liability, then the rate of profit or net bank margin (sharia) may go down if a decline in bank earnings due to the indirect effects of the decline in market interest rates. This is often referred to as the risk of bank assets to invest or we call it as a reinvestment risk. In general, due to a decrease in the rate of profit as a result of the influence either directly or indirectly on the bank's interest rate is often referred to as the spread risk which is a difference between income (revenues) of the asset and the cost of liability.[21] The Effects of changes in market variables such as interest rates to the rate of profit or a Net Profit Margin of Islamic banks has become very important because the structure of Islamic banks profit whereby 90-100% of the revenues derived from sale based financing products like *Murabaha* and *Ijara* that use interest rate benchmark (SBI or SIBOR). Any economic system needs a financial system that can maintain the level or rate of profit (margin) which is stable and sustainable to create the stability of the banking and capital market system.

Another risk that is often occurred due to the difference in the maturity of asset-liability re-pricing period of financial institutions is called mismatching that can create liquidity problem. Mismatching is the difference due to the principal amount of assets and liabilities of Islamic banks. Looking at the maturity of assets in the bank either in the form of investment or financing has an average maturity of over 1 year compared to an average maturity of liability with the majority in 1 month period. This has led the bank running the risk of mismatch which causing liquidity risk that may lead to subsequent risks which is more crucial called the reputation risk. This is because banks are not able to provide liquidity in a timely manner resulting in a run-off of massive liquidity so that the banks can’t operate anymore because it ran out of cash. From the above facts it can be concluded that the management of net profit margin or the rate of profit of Islamic banks becomes very important in maintaining the stability of the financial sector so that an economic system as a whole can work well. Some theories can be developed to manage the Net Profit Margin of Islamic banks to be stable and has sustainable growth at such repricing gap models and maturity gap models that adjusted the Net Profit Margin of the bank to be stable.

In addition, the risk of a decrease in Net Profit Margin due to the changes in interest rates could lead to the collapse of the asset value (market value) of the assets of fixed income in the bank so that it can lead to instability in the financial sector even worse. The theory that has been developed to manage

[20] George H. Hempel, Donald G. Simonson and Alan E. Coleman, *Bank Management; Text an Cases* (New York: John Wiley & Sons, 1994), Fourth Edition, 596.

[21] George H. Hempel, Donald G. Simonson and Alan E. Coleman, *Bank Management; Text an Cases*, 576.

the market value or the value of the bank's assets is duration and convexity gap models. Financial stability in an economic system can be seen from several factors: 1) The absence of a guarantee of a return on the principal of the placement; 2) Have a positive cash flow in the growing economy condition; 3) Do not face the asset-liability gap and mismatch and 4) Do not connect in the structure of loans (financing) with another bank so as to cause a domino effect.[22] Four of these factors greatly affect the stability of an economic system.

In today's Islamic bank assets and liability management techniques, known as Asset Liability Management (ALMA), that uses the ratio of Rate Sensitive Asset (RSA) and The Rate Sensitive Liability (RSL) as a representation of bank's balance sheet structure is basically the same as in conventional banks. Especially if we are looking at the balance sheet structure of Islamic banks' asset and liability that are dominated by the sale based product, the gap and mismatch of the asset and liability nature basically the same with its conventional counter party.[23] Therefore, in order to solve this instability risk in the Net Profit Margin, Hosein Askari in the opinion that the asset liability model of Islamic banks are ideal when there is no Islamic bank products that are based on the contract of sale and lease such as *Murabaha, Istisna, Salam* and *Ijara*. In the Islamic Bank ideal model which is developed by Hosein Askari, he described that ideally the assets and liability in Islamic Bank balance sheet should be only *Mudaraba* or *Musharaka* (equity based financing) products which is based on profit sharing scheme. This will create a perfect mirroring structure of balance sheet resulting in no gap and mismatch risk that will create instability in the bank Net Profit Margin.

However, practices which are majority prevalent in today's Islamic banking, in order to finance any project, *Murabaha* is used with the the rate of profit or mark-up which is fixed for long periods of time and they are using an interest rate benchmark such as LIBOR from conventional banks or SBI (in US we call it Fed Funds). The creation of the Asset Liability mismatch in Islamic banks which is the same pattern as conventional banks would create ALMA risk that will be strongly influenced by interest rates. If we use the financial measurement tools such as Duration and Convexity as a measure of market risk as a result from changes in interest rates, it can be ascertained that the duration of Islamic banks would always be away above zero. This is because that the majority (70-80%) of assets of Islamic banks are based on

[22] Hosein Askari, etc, *The Stability of Islamic Finance: Risk Profile of Islamic Financial Intermediaries* (Singapore : John Wiley and Sons (Asia) Pte. Ltd, 2010), 134.

[23] Hosein Askari, etc, *The Stability of Islamic Finance: Risk Profile of Islamic Financial Intermediaries* (Singapore : John Wiley and Sons (Asia) Pte. Ltd, 2010), 134.

the sale based product with a fixed mark-up (rate of profit) for long term. In theory, the ALMA structure of Islamic banks, on the other way around, should produce a "duration and convexity" that is close to zero (risk neutral) as to create stability in net profit of the bank.

The use of margin (rate of profit) in long-term fixed assets of Islamic banks in the *Murabaha* product massively, has create the negative gap of structure of the balance sheet (Rate Sensitive Asset / Liability Rate Sensitive < 0) or also called positive net refinancing. In the conditions of interest rate rises rapidly then this condition will result in adverse effect on the Net Profit Margin of the banks because banks are not able to make changes in the rate of profit of the assets (already fixed in the long term). These events are called "negative spread" in conventional banking whereby the rising interest expenses exceed the interest income of the Bank. In a state of economic overheating, as it did in 1998 in Indonesia, the "negative spread" phenomenon is prolonged and the loss had been continuously eroded bank capital resulting in almost all banks have to be rescued by Bank Indonesia Liquidity Assistance (BLBI). The banks that had to be bailed out by the central bank rescued by issuing Government Recapitalization Bonds (Recap Bond) amounting up to Rp 650 trillion.[24] This condition has to be expensively paid through the taxes by all of the people of Indonesia up to now.

In Islamic banking practices, the wrong application in the use of *Murabaha* transactions occurred in Home Ownership Financing Product with fixed and long term margin (rate of profit) for 10-15 years which create high volatility if we use duration and convexity risk measurement. This practice is certainly contrary to the principles of Economic Value of Time concept in the theory of Islamic Finance as a replacement of Time Value of Money principle. *Murabaha* margin (rate of profit) is inherently based on the principle of Economic Value of Time should be based on short term profit in the real market (goods market not money market) and should be used for short-term financing. Rate of profit used in *Murabaha* transactions as the economic value of a short-term profit then should be reprice according to the nature of the transactions in the real sector. For *Murabaha* the profit rate should be benchmarked against the leasing cost of the goods periodically. For instance, in car transaction it could be repriced once a month but for home financing it could be at least once a year like in home leasing transactions. This would create a risk neutral balance sheet transactions in Islamic Bank, because *Murabaha* transactions now quoted in fixed profit rate but periodically repriced in shorter term that will create value "duration" equal to zero. Almost similar to this practice was *Murabaha* products with a capped system and can be repriced according to

[24] See Sasmito Hadinegoro, “Stop Obligasi Rekap atau Tunda Bayar Pajak”, *Sindo Weekly*, http://m.sindoweekly-magz.com/artikel/19/i/12-18-juli-2012/ analysis /39 /stop-obligasi-rekap-atau-tunda-bayar-pajak. (accessed on 8 Maret 2013).

market rate (money market rate like JIBOR) was ever introduced and applied by Bank Syariah Mandiri. The difference with the concept of rate of profit is, they based/benchmarked on money market rate, like SBI plus, JIBOR or ATD (Average Time Deposit quoted by the State Banks) that is not based on the profit in the goods market like leasing cost in house/car transactions.

The argument that why the majority of the Islamic Banks today is still using the sale based products (*Murabaha*, *Istisna* and Salam), contrary to the Islamic economist against this transactions, said that these transactions are allowed by the majority scholar (*jumhur ulama*).[25] Naturally, this transactions are also needed by the Islamic Banks in order to offer a different product variants in the middle of the demands of customer demand that very wide and that the duty of the bank to create a stable asset-liability. Based on the principles of Islamic rate of profit, the transaction based on the contract of Sale Based Product or *Ijara*, the profit rate quoted either in the terminology of margin or leasing cost (*ujrah*) are not used for long-term transactions. In risk management perspective, the longer the period the greater the duration of its value, so the more unstable the change in rate of profit resulting in the more risk in revenue that can cause income and capital loss.

As a solution, Islamic Bank can use variations in contracts with the same financing purpose. For example in financing home or car purchases, instead of using *Murabaha*, Islamic Bank can use the contract called *Musyarakah Mutanaqishah* (MMQ) and *Ijara Muntahia Bittamlik* (IMBT), where by the rate of profit (*ujrah*) repriced periodically according to the profit in the goods market. In the study of the rate of profit concept, these transactions then can be used as a solution for creating a just and stable distribution of income as its rate of profit can be adjusted (reprice) according to the rate of profit in the real sector. Based on this principle, the supposed margin in *Murabaha* transactions as well as the leasing cost charged to the customer in MMQ and IMBT will be the same and also the nature of the rate of profit. In practice *Murabaha* rate charged to customers different in nature with a leasing rate that is charged on transactions of MMQ and IMBT. *Murabaha* quoted in fixed and long term rate meanwhile MMQ and IMBT quoted floating and reprice-able based on JIBOR or SBI even though both transactions were used for the same purpose of financing.

Based on the principle of Islamic economics, in accordance with the rules of Islamic Law, the practice of using *Murabaha* for long term transaction also violate the basic principles of *riba al-fadl* (excessive/exploitative profit). Based on this principle, Islamic banks will manage the rate of profit of the product based on the maturity nature of the transaction. The practice of this principle will separate the

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[25] Bank Indonesia, *Dewan Syariah Nasional Majelis Ulama Indonesia Fatwas, 2nd edition.* 21-39

management of Islamic banks into short-term assets (*Murabaha*, *Istisna* and *Salam*), medium term investment (*Ijara* and *Istisna*), and long-term partnerships (*Mudaraba*, *Musharaka*) portfolio.[26] With this asset-liability management system, the net profit/income of Islamic banks will not fluctuate due to changes in money market variables. In risk management theory, asset-liability structure with same repricing profile period on both side will create duration approaching to zero or risk neutral, so that it will be immune to the changes in market variables such as indirect interest rates (since Islamic Bank uses interest rate as a benchmark). Asset-liability management that implemented matched repricing profile will also have a sustainable rate of profit growth in line with the asset growth which will be distributed to the *Mudaraba* Deposits customer every month.

Furthermore, the rate of profit concept will be useful in determining the price of Islamic Bank assets like Financing. In its application, Islamic Bank uses the theory of Capital Asset Pricing Model (CAPM) and tries to adjust it with Islamic principles. CAPM theory states that in determining the rate of profit (return) of an investment can be divided into two formulas, namely: (1) Formula represents the risk free return or RF, (2) formula represents the risk premium as a compensation for additional risk bearing for the investor on an investment in a certain time period. The CAPM final formula is: RF + β (Rm - RF)).[27] The first formula is essentially to replace the element of the time value of money concept and the second is the formula concerning the risks associated with an investment in a project or the securities that are selected. If we viewed from the theory on how to determine the rate of profit based on this CAPM theory, the first element is basically based on the rate of interest concept which is the risk free interest rate. In terms of Indonesia case the risk free rate can be represented by Bank Indonesia Certificates (SBI) which is determined in the supply and demand of money in money market (market trade instrument below 1 year maturity). SBI interest rate then is used as the base interest rate (base rate) and benchmark rate in case of Islamic Bank for pricing ujrah or margin in the financial markets product and coupon for Indonesian bond product.[28] SBI considered as having no risk of default due to the consideration that the central bank as the issuer is part of the Government of the Republic of Indonesia.

Furthermore, using the basic theory of CAPM, Islamic bank extents this concepts for calculating the financing product such as other cost elements i.e. as operating costs (overhead costs), return on equity

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[26] Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Bank* (Washington : The World Bank, 2008), 19.

[27] Willian F. Sharpe, Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk, "*Journal of Finance*," Vol. 19, No. 3, 425. http://web.cenet .org.cn /upfile/ 17485.pdf.

[28] Adler Haymans Manurung, *Pengelolaan Portolio Obligasi* (Jakarta: PT Elex Media Komputindo, 2007), 41

for stake holder and risk premium for default risk to be charged to the customer. Structurally, all the interests of "profit" are determined exactly in front. Cost of funds component is the compensation given to depositors, whose value approaches the risk free rate of return at a different levels of maturity. This is in line with the Keynes's liquidity preference theory. Demand deposit, Savings and Time Deposits, at different levels of interest rates is in accordance with the purpose of the transaction and the time period. Demand deposit is used for transactional purposes get the lowest interest rates compared to the savings that are usually used as a precaution transaction and deposits for investment (speculation according to the terms of Keynes). Deposits interest rates varying in its yield curve in accordance with the expectations of interest rate and the liquidity premium added if the product to be quoted fixed rate for long term like *Murabaha* originally based on the theory developed by Hicks and Hansen.

Islamic banks that only know the rate of profit for their product then use the benchmark cost of funds from conventional banks which are speculative and its volatility based on the dynamics of the financial markets certainly does not fit with the character of the rate of profit that is guided by the real sector profits. While risk premium component that also added in the formula reflecting the additional burden to the company or the debtor, as an anticipation of bad credit or default risk costs which vary according to the type of industry. In practice, small customer like micro entrepreneur get the higher risk premium charge from the bank resulting in unjust treatment for this segment as they will pay expensive rate of profit. Finally, added by the management profit as represented by the Spread, the asset pricing formula becomes:

Cost of fund + Overhead Cost + Risk Premium + Spread[29]

In practice, the components of risk premium imposed on the segment of micro and small businesses, far exceeded the other components such as the cost of funds, overhead costs and the spread (ROA). Other additional practice is often applied in Islamic Banking called Term Premium which is basically an extra charged due to the fixed pricing quoted for its rate of profit because of the long maturity of the financing such as *Murabaha*. The longer the maturity, the greater the additional premium will be. With the percentage of bad loans are small, then from all the components of the income that earned from

[29] See Ismail, *Bank Management* (Jakarta: Kencana Prenada Media Group, 2010), 136.

financing, the portion of a risk premium, the return on asset for the banker and the term premium is the most dominant component when we compared to other components, so that the financial system such as this would create an unfair income distribution or in terms of the Quran, only circulated among the wealthy amongst you.

In Islamic financial institutions, the term of the cost of funds is not known because it is predetermined and calculated based on the simple or compounded time value of money considered as usury transaction which benefit only the investors. The risk premium is added to address the risk of uncertainty/default risk (according to the opinion of Paul Samuelson) which is charged to the loans taker to ensure the return of the loan.[30] This practice against the Islamic principle because it would mean eliminating the element of risk which is one of the legal reason to allow the profit-making ('*iwadh*) by *the rabb al-maal* (owner of the funds) in the real sector transactions. Samuelson opinion is contrary to the opinion of Muhammad Baqir al-Sadr stating that the risk of uncertainty/default (risk premium) is not a factor of production and therefore the additional profit is not legal to be charged as a compensation for this risk.[31] Profit component to compensate business risk actually can be represented by the spread or return on asset components, i.e. the appropriate level of risk being taken for profit which is allowed by Islamic principles ('*iwadh*), as long as not persecute one another or exploitative.

In determining the rate of profit, Islamic Bank should have the real profit proxy that will used as a benchmark which is not speculative (real) and not exploitative, taken from gains in the goods market or the real sector. In taking profit proxy from cash transactions, for example Islamic Bank should not take interest rates in the money market as a benchmark. GDP which is calculated based on the value added of the national production of goods can represent (proxy) a minimum profit rate (rate of profit) nationally, as it is a measure of the level of output of 19 goods produced in the country. This opinion is basically in line with the opinion of Piero Sraffa as the basis for the calculation of the rate of profit.[32] After that in calculating the price of financial assets in Islamic banks, we can add other factors like the cost that should be recovered such as: Over Head Cost (OHC) and the profit rate coming from asset turnover in the period of financing (Return on Assets) expected by management at the appropriate reasonable industry level. So

[30] Paul Samuelson, *Economics*, 10th edition (Tokyo: MacGraw Hill, 1976), 618

[31] Muhammad Baqir al-Sadr, Iqtisaduna (Beirut: Dar al-Fikr, 1961), 559

[32] Piero Sraffa, *Production of Commodities by Means of Commodities: Preclude to a critique of Economic Theory* (Bombay: Vora & Co., Pub;ishers PVT.LTD, 1960), 6 http:// laprimaradice.myblog.it /media /02/02/ 2829581832. pdf (accessed on 15 Mei 2013)

based on this theory, the price of financial assets at Islamic financial institutions, according to the author should be:

$$GDP + OHC + ROA$$

Thus, based on the above general formula, the rate of profit in Islamic Bank should be cheaper and provide *maslahah* (benefit) than conventional banking because it creates an equitable income distribution when compared to lending rates in conventional bank loans.

The risk of financial instability in the bank net income can be measured by the volatility of portfolio net worth (PNW) per market value of asset that had been managed as below:

$$d\,(PNW/A) = -dG\,.\,dR + CG/2\,.\,dR^2/(1+R) \qquad \text{whereby} \quad CG = CA - (L/A).CL$$

CA = Convexity Aset, CL = Convexity Liability, L = Matek Value of Asset, A = Market Value of Liability, D = Duration and R = (interest) Rate

3.1.1. Empirical Study of Financial Stability in the Asset Liability Management in Islamic Banking

To support this qualitative research (related to the concept) and to measure financial instability in Islamic Bank net income/margin, the author conducted a quantitative verification by doing an empirical studies on the influence of interest rates on the rate of profit of one of the biggest Islamic bank in Indonesia (a case study).

For the empirical studies, author took the data of rate of profit growth of Bank Syariah Mandiri (BSM) from May 2004 to May 2009. The year 2004-2009 is chosen because at that period there was an interest rate hike from 7.25 % to 12.25 % due to the financial crisis in United State of America. This condition is ideal when we want to look at the effect of interest rate hike on the rate of profit of Islamic Bank. In a study conducted at Bank Syariah Mandiri from 2004 to 2009 author study the bank's rate of profit which is calculated from the portion of a Islamic bank profit apart from the customer portion represented by Net Profit Margin (NM). The model used in this study is multiple regression time series model, because in this study there is only one dependent variable and more than one independent individual variable. In this analysis we will look on how big the influence of independent variables on the dependent variable. In this study, the independent variable is a numeric variable, since the independent variables were taken from the data of the financial statements of Bank Syariah Mandiri and Bank Indonesia publication data. The type of data is a time series data in the period of May 2004 to May 2009 (5 years).

The model used is a model with multiple regression analysis to determine the effect of 5 Factors i.e. : Balance Sheet Structure of Islamic Bank represented by the ratio of RSA/RSL (Rate Sensitive Assets / Rate Sensitive Liabilities), Islamic Bank Investment in Real Sector represented by the ratio FDR (Financing to Deposit Ratio), Interest Rate represented by the SBI (Bank Indonesia Certificate), Islamic Bank Capital represented by the CAR (Capital Adequacy Ratio) and Islamic Bank Credit Default represented by the NPF (Non Performing Financing) to rate of profit of Islamic Bank represented by the Net Profit Margin to Deposit (NM) of Bank Syariah Mandiri. From the research results shows that the Net Profit Margin of Islamic banks turned out to get affected by the interest rate movement. In this research we are using the interest rate of SBI (Bank Indonesia Certificate) as a comparison. The Research models also illustrate the instability of BSM Net Profit Margin/income to changes in interest rates, represented by the SBI and other independent factors as below:

$$\textit{Net Profit Margin} = \alpha + \beta 1\ RSA / RSL + \beta 2\ SBI + \beta 3\ FDR + \beta 4\ CAR + \beta 5\ NPF + \upsilon$$

The result from the statistical analysis shows a relationship of Net Profit Margin (NM) and its independent factors i.e. the Islamic Bank Balance Sheet Structure, SBI (Interest rate) and Capital as below:

The Overall Model F test (ANOVA) conducted with the hypothesis:

H_0: $\beta 1 = \beta 2 = \beta 3 = \beta 4 = \beta 5 = 0$, meaning that the RSA / RSL, FDR, SBI, CAR and NPF
Are not significantly affect the Net Profit Margin

H_1: At least one $\beta \neq 0$, meaning that the RSA / RSL, FDR, SBI, CAR and NPF
Together significantly affect Net Profit Margin

Statistical analysis was performed with the decision criteria: Reject H_0 if the p- value of the F statistic is smaller than 0.05

Table 2. ANOVA Test for Overall Model Validity

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	22.967	5	4.593	46.694	.000[a]
	Residual	5.411	55	.098		
	Total	28.378	60			

a. Predictors: (Constant), NPF, LDR, SBI, CAR, RSA/RSL

b. Dependent Variable: NM

Source: SPSS Output

Tabel 3. *R Square* Test for Overall Model Validity

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.900[a]	.809	.792	.31365

a. Predictors: (Constant), NPF, LDR, SBI, CAR, RSA/RSL

b. Dependent Variable: NM

Source: SPSS Output

The output according to Table 3 above: p-value statistic F is 0.000 less than 0.05, it can be concluded that reject H_0, which means that the variable RSA / RSL, FDR, SBI, CAR and NPF together significantly affect the Net Profit Margin of Bank Syariah Mandiri . The results of the R - square of 0.809 indicates the strength of relationship between the variables of the five independent variables is: RSA / RSL, FDR, SBI, CAR and NPF to Net Profit Margin of Bank Syariah Mandiri.

From the BLUE (Best Linier Unbiased Estimator) test, the FDR and NPF are proved to have a multi collinear problem as shown by high condition index of 79.489 which is larger than 30, so the author has to do VIF test with the result as Table 4 below:

Table 4. RSA/RSL, SBI and CAR Variable Test

Coefficients[a]

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.	Collinearity Statistics Tolerance	Collinearity Statistics VIF
1	(Constant)	11.270	.372		30.285	.000		
	RSA/RSL	-.015	.004	-.210	-3.272	.002	.847	1.180
	SBI	-.228	.023	-.596	-10.072	.000	.996	1.004
	CAR	-.225	.027	-.538	-8.405	.000	.850	1.176

a. Dependent Variable: NM

Source: SPSS Output

The results in Table 4 SPSS output shows only three variables: RSA / RSL, SBI and CAR have VIF smaller than 10, so from this VIF test these three variables do not have a multi collinear problem. To further provide satisfactory results, the researcher did another test with Condition Index Test with the results as shown in Table 5.

Table 5. Collinearity Diagnostics RSA/RSL, SBI and CAR Variable Test

Collinearity Diagnostics[a]

Model	Dimension	Eigenvalue	Condition Index	Variance Proportions (Constant)	Variance Proportions RSA/RSL	Variance Proportions SBI	Variance Proportions CAR
1	1	3.921	1.000	.00	.00	.00	.00
	2	.048	9.002	.01	.68	.25	.00
	3	.023	12.950	.07	.29	.58	.22
	4	.007	23.279	.92	.02	.17	.78

a. Dependent Variable: NM

Source: SPSS Output

The end result as shown in Table 5 is the value of Condition Index of 23.279 less than 30 indicates that the multi collinear symptoms can be addressed and the research to test the overall model and the individual testing with these three variables can be done to get the exact model.

Testing the overall model of the three variables do with the hypothesis:

H_0: *RSA / RSL, SBI and CAR* has no effect on Net Profit Margin

H_1: *RSA / RSL, SBI and CAR* has effect on Net Profit Margin

With the testing criteria: Reject H_0 if the p-value test statistic F in the ANOVA table > 0.05.

The results of the overall test models such as the Table 6 below:

Table 6. The Overall Model RSA/RSL,SBI and CAR Test

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	22.741	3	7.580	76.647	.000[a]
	Residual	5.637	57	.099		
	Total	28.378	60			

a. Predictors: (Constant), CAR, SBI, RSA/RSL

b. Dependent Variable: NIM

Source: SPSS Output

Table 7. R-Square Overall Model (RSA/RSL, SBI and CAR) Test

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.895[a]	.801	.791	.31448

a. Predictors: (Constant), CAR, SBI, RSA/RSL

Source: SPSS Output

Because in Table 7 p-value of 0.000 <0.05 , then reject H_0 means that together the three variables, namely RSA / RSL , CAR and SBI has effect on Net Profit Margins.

Testing the hypothesis of individual partially performed by t test with a hypothesis:

The results of the t test output to variable RSA / RSL , SBI and CAR as shown in Table 8 below:

Table 8. RSA/RSL, SBI and CAR Variable t-Test

Coefficients[a]

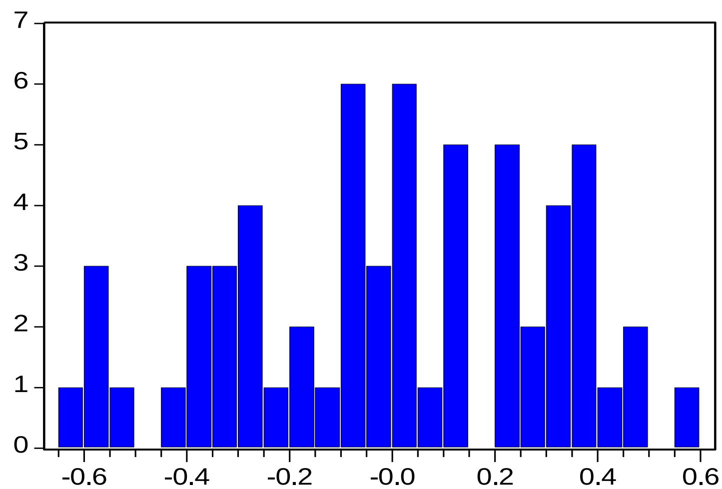
Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	11.270	.372		30.285	.000
	RSA/RSL	-.015	.004	-.210	-3.272	.002
	SBI	-.228	.023	-.596	-10.072	.000
	CAR	-.225	.027	-.538	-8.405	.000

a. Dependent Variable: NM

Source: SPSS Output

From the Examination on the final model with 3 variables: RSA / RSL , CAR and SBI , which is freed from the multi collinear problems, the research continued by testing the remaining BLUE test namely : Normality Data Test with Jarque Berra Test, Homoscedasticity Test with White Heteroscedasticity Test, Autocorrelation Test with Breusch-Godfrey Serial Correlation LM . The results from Eviews output is as follows:

Table 9. Jarque Berra (RSA/RSL, SBI, CAR) Normality Data Test



Series: Residuals	
Sample 1 61	
Observations 61	
Mean	-1.37e-15
Median	0.023747
Maximum	0.598513
Minimum	-0.638121
Std. Dev.	0.306518
Skewness	-0.220829
Kurtosis	2.210281
Jarque-Bera	2.080908
Probability	0.353294

Source: Eviews Output

The results in Table 9 Eviews output as shown above indicate normal distribution for residual with a p-value 0.353294 is greater than 0.05 .

Tabel 10 Uji White Heteroscedasticity (RSA/RSL, SBI, CAR)

White Heteroskedasticity Test:

F-statistic	1.654022	Probability	0.150345
Obs*R-squared	9.470162	Probability	0.148812

Source: Eviews Output

Output results from Table 10 shows that the p-value 0.148812 > 0.05, so it can be concluded that the residual is homoscedastic.

Table 11. (RSA/RSL, SBI, CAR) Variable Autocorrelation Test

Breusch-Godfrey Serial Correlation LM Test:

F-statistic	0.710304	Probability	0.495947
Obs*R-squared	1.535911	Probability	0.463961

Source: Eview Output

Output results in Table 11 shows the p-value testing from Breusch Godfrey Serial Correlation LM Test is: 0.463961 then it means there is no problem of autocorrelation.

So from the overall test, it can be concluded:

1. The Significance value/ t statistical p-value for the variable RSA / RSL (Balance Sheet Structure) is 0.002 < 0.05, then RSA / RSL has effect on Net Profit Margins.
2. The Significance value/ t Statistics p-value for the variable SBI (Interest Rate Benchmark) is 0.000 < 0.05, then SBI has effect on Net Profit Margins.
3. The Significance value/ p -value for the variable CAR t-statistic is 0.000 < 0.05, then CAR has effect on Net Profit Margins.

So that the final model is:

$$\begin{array}{l} NM = 11.270 - 0.015\ RSA/RSL - 0.228\ SBI - 0.225\ CARt \\ \quad (30,285)\ \ (-3,272) \qquad (-10,072) \quad (-8,405) \\ se\ \ (0.372) \quad (0.004) \qquad (0.0023) \quad (0.027) \\ R^2 = 0.801 \end{array}$$

From the resulting research model above, the model can be interpreted as follows:

1. When the other variables are constant, the increase of 1 % in RSA/ RSL would decrease the Net Profit Margin value of Bank Syariah Mandiri to 0.015 %
2. When the other variables are constant, the SBI rise of 1% would reduce the value of Bank Syariah Mandiri Net Profit Margin to 0.228 %
3. When the other variables are constant, the increase in CAR of 1% would reduce the value of Bank Syariah Mandiri Net Profit Margin to 0.225 %.

The value of R square shows 0.801 which means the variables of RSA / RSL, SBI and CAR are all able to explain with the same behavior amounted to 80.1 % Net Profit Margin at Bank Syariah Mandiri, while 19.9 % is explained by other variables

From the above model it can be interpreted that every 1% increase in the SBI rates will cause a decrease in the rate of profit of BSM amounted to 0.228%. From this empirical data it can be concluded that the nature of the instability of Islamic banks to interest rates hike with the balance sheet structure (RSA / RSL) below zero (negative gap), will produce the same risk with conventional banks, namely the decline in the rate of profit of Islamic banks. In other words that the rate of profit character of Islamic banks is the same as the character of NIM (Net Interest Margin) of Conventional Banks with the Interest Rate System. Therefore the rate of profit in Islamic banks and Islamic bonds in the capital market should refer to the Islamic Benchmark referring to the profits in the real sector with mark to market methodology which inherently have low duration (volatility) as it will bring stability to the economy both in the banking system as well as the Islamic capital market.

3.2. Rate of Profit Role in Creating Equitable Distribution of Wealth Measured by the Volatility of Asset Value of Islamic Finance

Basically, all financial assets have cash flow in the form of cash inflows and outflows. Cash inflows can be in the form of installments in the financing contract in Islamic banks, coupons paid by the issuer of Islamic securities and income from investments in the real sector. Cash inflows and outflows can include cash flows that are fixed and predetermined (fixed and ex ante) and cash flows that are not fixed and determined at the rear (variable and ex post). In the Islamic financial system, the cash flow that is fixed and predetermined can be seen on the sale based transaction such as *Murabaha*, *Istisna* and Salam as well as the transactions that are based on the leasing agreement such as: *Ijara* and *Ijara Muntahia bit Tamlik* (IMBT). It's fixed and predetermined, because margin or mark-up (in this paper we call it as a rate of profit of the sale based product) is determined ahead and remain unchanged within the prescribed period.

From the characteristics of the transactions that generate cash flows that are fixed and pre-determined like this sale based transactions, then the value of a financial asset can be measured. The stability of the financial assets can thus be measured by the value of the asset changes to the change in the benchmark used in determining the transaction price (such as margin, mark up, *ujrah* and all kind of rate of profit) which involved rate of interest as the benchmark such as SBI (if the instrument denominated in Rupiah) and LIBOR (London Interbank Offered Rate) if the instrument denominated in US Dollar. In theory, the measurement of the value of a financial asset can be determined by The Duration theory.[33] The risk of financial instability thus can be measured by the volatility of financial asset prices derived from the formula:

$$(dV / V) = -n\ (dR / 1 + R)$$

In other words, changes in the value of financial assets (including Islamic Financial Asset) can be affected by the changes in the benchmarks used to assess an asset. For example if interest rate is used as a benchmark on the formula in *Ijara* or *Murabaha* contract, any change in interest rates at 1%, it will cause changes in the value of an asset or assets by: -1 (0.01 / 1.1) for assets with a maturity of one year or at - 0.91%. If a period longer used for example 5 years, the risk of price changes becomes larger assets, namely: -5 (.01 / 1.1) = -4.55%. So the management of financial assets with the interest rate benchmark is

[33] Goerge H. Hempel, *Donald G. Simonson, Alan B. Colemean, Bank Management: Text and Cases* (New York: John Wiley & Sons, Inc, 1994), 599.

very vulnerable to the decline of asset price, which means that it will decrease the public wealth (the investor of the financial asset) in the form of the decline in the value of financial assets.

From this theory can be concluded that the Long Term *Murabaha* financing transactions, for example to finance home ownership, which is usually take a period of 15-20 years have a very large volatility i.e : 13.65% for *Murabaha* with a maturity of 15 years and 18.2% for *Murabaha* with a maturity of 20 years. Here the author concluded that the use of interest rates in Islamic transactions causing instability in the value of financial assets that can be detrimental to investors and lead to instability of the financial system as a whole, i.e both in financial institutions and Islamic bonds like Sukuk. For instance Government *Ijara* Sukuk SR01 Series with 12 percent p.a. coupon payment with a maturity on February 25, 2012 has ever reached the price of 107.7199 or appreciation of 7.7199 percent above the par (initial) level. While the Government Sukuk Series IF8 price with a coupon of 8.8 pct maturing March 15, 2020 had reached 98.50 price or suffer a capital loss of 1.5% of their principal amount.[34] The price movements of financial assets that can suffer a capital loss (the wealth decline) will lead to instability of the Islamic financial system, due to instability in asset-liability management of Islamic banks, which in turn affects the wealth of the society who invest funds in Islamic banks.

According to the Global Association of Risk Professionals, the interest rate charged on a loan is determined by a number of factors such as time period, namely: 1) Cost of Fund; 2) Spread / margin required for such products; 3) Market Conditions (how much is paid by competitors); 4) The period of the instrument.[35] Bank charges interest (rate of interest) on the credit transaction or financing for various ranges of period. Problems on the fourth factor in Islamic Banking because the loan interest rate is calculated based on the theory of Fischer's (The Theory Of Expectation), in which the determination of long-term rates based on the expectations of short-term rates in the future.[36] The Expectation theory is based on the calculation which create structure of interest rates or commonly known as the yield curve in the bond market (capital markets) in the form of positive slope (the longer the period, the interest rate will be higher). The determination of an additional element of term premium as a time-element component is made at the initial stage of agreement without any basis or guided by the profit or loss (rate of profit) in the real sector. Additional premium term is just following the trend prevailing interest rates in the money market and is linear based on the concept of the time value of money. In other words the concept of rate

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[34] Bloomberg Company, www.bloomberg.com (accessed on June 4, 2010).

[35] *Indonesia Certificate in Banking Risk and Regulation*: Work Book Level 2 (Jakarta: Badan Sertifikasi Manajemen Risiko, 2007),49.

[36] Andrea Resti and Andrea Sironi, *Risk Management and Shareholders' Value in Banking: From Risk Measurement Models to Capital Allocation Policies*, (Chicester, West Sussex, England: John Wiley & Sons Ltd, 2007), 28.

of profit used in *Murabaha* margin has followed the concept of rate of interest. Based on the research result, if Islamic Bank use interest rate as benchmark, it has significant effects on the value of the portfolio of asset and liabilities.

According to Islamic profit theory, the rate of profit taken in front in the Islamic transactions like sale-based products should be based on cyclical gains (circular repricing pattern) per transaction according to its economic value. If this concept is applied, the rate of profit in a long-term deal, Islamic Bank has to do a mark to the market (MTM) process (the comparison with the rate of profit in the real sector) periodically. In other words, the price adjustment should be carried out periodically as compared to the level of profits in the goods market (repricing) in order to avoid the practice of adding without *illat / 'iwadh* according to the rules of Islamic jurisprudence.

In general, the current imposition of *Murabaha* profit based on money market rates plus a fixed term premium, basically based on Islamic Bank decision to overcome fears of rising interest rates on the long-term. Therefore, if interest rate unchanged, in practice Islamic banks will give *muqasah* (discount) every month or every year.[37] So muqasah is provided as a means for adjusting the gain (rate of profit) with market rates (rate of interest). According to the author, based on the analysis of *iwadh* (legal profit), the uses of risk premium and term premium as additional price component in Islamic Bank, are groundless. Instead of using fixed and long term rate of profit, we should use a circular/periodic rate of profit appropriate to the level of profit in the real sector. Rate of profit is circular (as opposed to interest rates that are linear), as a gain in the trading transaction in the period of sale of goods or services. Turn-over of goods sometimes fast and sometimes slow.[38] If it is faster, the gain will be big. If it is slow, the gain will be little. So, the gain or rate of profit will follow the pattern of an economic growth.

4. CONCLUSIONS

In conclusion, the stability on Islamic Financial Market which is measured from the equitable distribution of income and the wealth of financial asset in Islamic Bank Net Profit Margin will be determined by:

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[37] Wiroso, *Murabahah Sale*, 93

[38] Nadratuzzaman Hosen, Maulana Hadanuddin dan Hasan Ali, Islamic *Economic Principles* (Jakarta: Pusat Komunikasi Ekonomi Syariah, 2009), 134.

a. As shown by the research result, the net gap arising from Islamic Bank balance sheet structure (RSA/RSL < 0) due to the dominant long term and fixed Murabahah asset has bad impact on Islamic Bank Net Profit Margin in a rising interest rate condition. In order to have a more stable Asset-Liability Management, Islamic Banking should follow the concept of an Islamic Rate of Profit whereby the profit will always be marked to the market with profit in real sector and this will result in the net duration of the Islamic Bank balance sheet will be approach to zero or risk neutral so that it will be immune to the changes in market variables such as interest rates. The rate of profit in Islamic Bank that creates an equitable distribution of income as measured by the stability of the Net Profit Margin on Asset-Liability Management of Islamic banks, can be achieved by structuring the Islamic banks rate of profit repricing profile based on short-term assets (*Murabaha*, *Istisna* and *salam*), medium term investment (*Ijara*, *Istisna*) and long-term partnerships (*Mudaraba*, *Musharaka*).

b. The rate of profit that creates an equitable distribution of wealth in the Islamic capital market also can be seen from the volatility of financial assets such sharia Islamic bonds (sukuk). From the economic analysis, we can see the main factor is a component of risk and term premium for long term being added in the pricing structure of Islamic financial assets such as Islamic bonds which is basically the same additional charged on the loan pricing structure for compensation due to the credibility of the borrower's. This risk premium together with the long term premium structure creates price volatility which comes from the high duration factor. With the concept of rate of profit which is accordance with Islamic principles, the rate of profit will be corresponding to the profit in the real sector and has always adjusted to the changes in the price in the real market (mark to the market methodology) so that the price of the *sukuk* will be more stable.

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Designing and formulating action plan for development of corporate citizenship in producing units in Iran

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Abstract

Corporate citizenship is considered as one of the most discussed topics in the developed countries, in which a citizen considers a Corporate just like a usual citizen with every civil right as respectful for corporate as for actual citizens, and in return citizens expect that corporate would pay a reciprocal respect to them.
The current study's purpose is to identify the impact of the current state of corporate citizenship along effective factors on its condition on industrial producing units , in order to find an accession plane for corporate citizenship development.
In this study corporate citizenship is studied in four dimensions like legal corporate, economical corporate, ethical corporate and voluntary corporate.
And Effective factors' impact on corporate citizenship is explored based on threefold dimensional model: behavioral, structural and content factors, as well.
In this study, 50 corporate of Food industry and of petrochemical industry, along with 200 selected individuals from directors' board on Tehran province's scale with stratified random sampling method, are chosen as actuarial sample. If based on functional goal and compilation methods, the present study is a description of correlation type; questionnaire is used for accumulation of initial Data. For Instrument Validity expert's opinion is used .and structural equations and its reliability is qualified by using Cronbach Alpha.
The results of this study indicate that close to 70 percent of under survey corporate have not a good condition in corporate citizenship. And all of structural factors, behavioral factors, contextual factors, have a great deal of impression and impact on the advent corporate citizenship behavior in the producing Units. Among the behavioral factors, social responsibility; among structural factors, organic structure and human centered orientation, medium size, high organizational capacity; and among the contextual factors, the clientele's positive viewpoints toward corporate had the utmost importance in impression on under survey Producing units.

Keywords: Corporate Citizenship, structural factors, behavioral factors, contextual factors, producing units

Introduction

Corporate citizenship, as an outstanding term in management literature which deals with social business, appeared in late twentieth century. Its roots in management field dates back to 1980s. Of its visible marks and signs on the global process are the common statements notifications about the Global Corporate Citizenship. Global Corporate Citizenship is a theoretical framework for correlation and support of all stakeholders of various industries on a global scale. International institutes of Global Corporate Citizenship advocate are looking for economic development on an international scale .According to theories of socialism, Corporate legally have some obligations and tasks towards local and global stakeholders. (Anderson, Rachelj, & Williams, (2009)).

one of the most important competitive advantages for Global Corporate is To have Corporate citizenship elements ,such as : Ethics and suitable governance which means adherence to global standards ,terms and conditions , prevention of bribery, emphasis on implementation of the Public Defender's policies , regard for business and ethical principles , and human rights which itself includes : equal chance of employment , nondiscrimination , preventing child labor excretion ,having freedom in forming Unions and Associations , and at last , equal payment to employees (Gardber,2006).

Abundance of "Corporate Citizenship" term is not limited to Organizations' domain, but it is applicable to an obviously visible series of academic studies which are assigned to these topics. A number of Corporate Citizenship magazines have carried out some researches in this framework .Conducted studies in Boston College ,USA ; Ejiat university, USA; and Uric university ,England; Elkin university of Australia are all amongst those studies in this field Most of business consultants have accepted "Corporate Citizenship" as a compliance to environmental and social policies of Corporate a number of governmental Units like :Consultants , Central Chamber of Commerce and African institute of Corporate Citizenship have had great developments in this field (Matten, Dirk & Cranc, Andrew, (2010)).

Conducted studies in those fields which are related to Corporate Citizenship, indicates that those corporate that have been faithful to inter-corporate ethical principles have more competitive advantages, but although in short terms they may suffer insignificant losses, they will enjoy a high proficiency in long terms and their operation would turn more positive and accountable due to their gathered fame. This Corporate have managed to strive well in acclaiming their own organizational goals by increasing motivation in their manpower and by the development of organizational commitment in them (Matten, Dirk & Cranc, Andrew, (2010)).

today , according to carried out studies , one of the most substantial challenges that Corporate are facing is Reducing social responsibility ,reducing social accountability ,and reducing social functioning of corporate in their confrontation with ahead crises (Choi, D.Y. & Gray. E. R. (2008)). Corporate Citizenship is considered as one of the most instrumental strategies in requiring organizations to incorporate ethics into their interaction with their environment. According to Mignan (1997) Corporate Citizenship is actually defined as commitment to implementing ethical behavior in strategy formulation and execution, and also it is defined as operations and business cultures in relation to the society in which they are operating.

Corporate Citizenship is Corporate' involvement in those activities that are of special importance to improvement of social issues which are beyond requirements.

Corporate Citizenship finds corporate' social responsibility as the process of wealth accumulation, promotion of competitive advantages of corporate and maximizing the value of the accumulated wealth, that generally considers total attention and commitment of businesses to the quality of life for employees, clientele, local society , as a way to achieve sustainable economic development (Holme, R & Watts, P. (2000).

What we have broached in the following study as research topic, is lack of awareness of the current state of Corporate Citizenship behavior in manufacturing industries of state, and also not having any pre-programmed plan which could lead us away from the sates quo to a more desirable state whereby utilization of these behaviors would be available. Accordingly and also because there has not been a conducted study on a national scale, researchers and associates are after analyzing and studying the current state of Corporate Citizenship behavior in industrial producing units due to their importance, they are also after identifying effective factors on its development process, so as to propose strategies and guidelines to authorities and practitioners which promote corporate Citizenship.

Theoretical Basics

If we grant that the ultimate goal of all of humans' bustles and economical activities is preservation and promotion of human dignity, then we would perceive why the conception of Corporate Citizenship has transformed into a prevalent and dominant paradigm in the past decade, and that why reputable and large global corporate find responsibility to social environment as a part of their strategies.

This concept is such a one that right now, in developed countries and countries with open economic, is being fiercely perused by all authorities like government, corporate, civil society, international organization and scientific centers.

Governments are looking at social responsibility as one of several dimensions of organizations' Corporate Citizenship in terms of responsibilities and task division and in terms of Moving toward a sustainable development.

Corporations take Corporate Citizenship behavior as a commercial strategy that adds on their reputation on a highly competitive environment and increases their stakes in market.

Since Civil society and nongovernmental organizations are aware of financial scandals and disasters resulting from corporate' performances, they expect social responsibility from corporate.

Regarding the fact that effects and influences on modern world is much more produced by corporate than governments, International Organizations find solving global challenges impossible without corporate' association and cooperation, and yet most of the politicians who are somehow directors of corporate, expect Corporate citizenship from corporate.

Scientific centers are viewing Corporate citizenship behavior from a perspective that involves corporate roles in a nation's development, in democracy's outspread, task interference and responsibilities of a corporate along that of government and their overlapping results, as well (Locke, M,Richard,& Siteman, Alvinj, (2010)).

Corporate citizenship includes four fundamental types which are: Economic Citizenship, Legal Citizenship, Volunteer Citizenship, and Ethical Citizenship.

Economic Citizenship is applied to a corporate' commitment in producing lucrative benefits for employees and other stakeholder by providing job opportunities ,gratuity, training and producing high quality products or providing their sale and services in a lucrative method.

Legal Citizenship is applied to a corporate' commitment to fulfillments of trade missions in a framework of legal requirements.

Ethical Citizenship is applied to corporate' commitment to subjection to ethical disciplines that represents appropriate behavior in society.

Volunteer Citizenship indicates those corporate' commitments to involvements in activities that are not supervised or controlled and that are not legally necessary, and that they do not predict a business in an ethical sense (Mclntosh Malcolm & Thomas Ruth, 2004).

According to Mclntosh , Carol(2004) also believes that commitments of corporate' and business owners are under these four titles of Economical , legal , ethical and volunteer, for achieving which there is definite methods and guidelines in society.

Business owners pay their tribute to potential profitability of market, for which they are responsible, by producing commodity and those services for which there are demands in society.

They have to follow appropriate behaviors' codes and rules which are ratified by legislators of nation (Legal responsibility) and they have to perform ethical standards (ethical responsibility). It is predicted that corporate are taking more part in improving society than the minimum standards through economical, ethical and legal responsibilities that are imposed on them. This matter also represents their volunteer responsibilities in participating in distribution of commodity, and in improvement of peoples' life quality.

In several of the past years, replication to demands of stakeholders and also efforts in promoting social values has brought up a complex contradiction that various committed commercial organizations are involved with it.

Seeking compromise and the need to have balance between demands of stakeholders and demands of society is a topic that is being defined in theoretical framework of corporate social responsibility and it helps to improve the relation between business and society.

, In the conducted studies in the field of Corporate Citizenship, we can referee to King and Deborah'S account of effective factors on formation of Corporate Citizenship.

They believe that magnitude of corporate, structure of corporate and social capital of corporate will influence the formation of Corporate Citizenship.

Accordingly organizations with large size, flexible structure and with appropriate social capital are more apt in forming attitudes of Corporate Citizenship (King,Derba and Makinnnon, Alison,(2000).

In a research, they have focused on surveying the influence of codes of conduct and moral intelligence on Corporate Citizenship. The results of this study indicate that at those companies and organizations that commitment to high ethical standards and moral intelligence improvement is emphasized, employees have more motivation in showing the attitudes and signs of Corporate Citizenship.

The results of these studies shows that at those corporate that Corporate Citizenship rate is high, individual, social and organizational positive outcomes are high as well. Today one of the corporate competitive advantages on a global scale is having attitudes of Corporate Citizenship. This matter in both developed countries and developing countries is emphasized on as an important commercial principle.

Conceptual model/ Research questions

In the present Basic studies, researchers have put the Trifurcation theory of deceased as the base of their studies, in addition to studying theoretical basics, present extant theories, carried out studies, surveying elites and experts in the field of conceptual model.

It must be noted that in many studies on surveying Effecting factors on a special phenomenon which were carried out nationally, this model has been used.

Repetition in using this model in numerous studies ,made researchers use this model in the present study in identifying effects of various factors on Corporate Citizenship behavior as guidelines and solutions for development of these behaviors.

It must be noted also that dimensions and parameters of this model have been obtained through studying the present theories, other conducted studies and surveying Elites and experts.

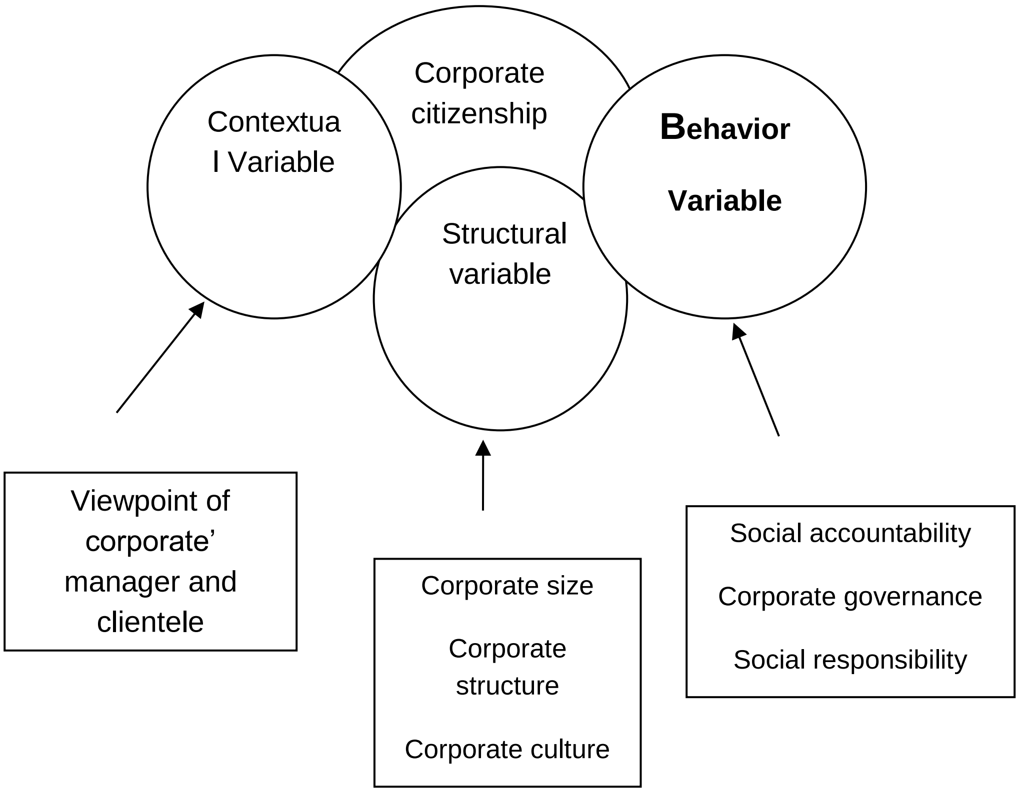

Figure1: Conceptual Model for corporate citizenship

Based on the above model, the research questions would be broached as followings:

First question: how is the condition of corporate Citizenship of Iranian production corporate active in industrial Units?

Second question: to what extent do structural variables affect the corporate Citizenship of Iranian Production corporate active in industrial units?

Third question: to what extent does a behavioral variable affect the corporate Citizenship of Iranian Production corporate active in industrial units?

Fourth question: to what extent does underlying variables affect the corporate Citizenship of Iranian Production corporate active in industrial units?

Fifth question: Based on what ground and plan can a corporate move from the current condition towards a more desirable condition?

Research methodology

On the base of practical goal and on the base of data compilation method, the present research is a description of types of surveying and correlation. Methods of Reading and surveying have been used for accumulation of data. Reading method has been used for editing theoretical basics, history and designing conceptual model, and Surveying method has been used for compilation of initial data of research sample through using questionnaire. The actuarial sample of this research includes all members of broad of directors of all active corporate in petrochemical and food industry of Tehran Province that their stocks has been accepted at Tehran Stock Exchange. According to corporations of Tehran Industrial Parks, fifty corporate with an employee board of 5000 and with a Broad of directors of 200, in Food clothing industry and petrochemical industry In Tehran, are having activity with a relativity of 45 and 55 percentage. In this study was used of questionnaire tools for data gathering. Using questionnaire complex 5 questions for measuring socio–demographic, 31questions for measuring corporate citizenship and 50 questions for measuring factors impact on CC. 18 questions for measurement of behavioral factors, 18 questions for structural factors and 14 questions for contextual factors.

In the present study questionnaire papers were sent for all 200 members of broad of directors, and 169 (84.5%) of the questionnaires were sent back to us. We took into regard the viewpoints of informed individuals to the subject for determining the Validity of Questionnaire Content. For structural Validity, Croit Bartelt Test with using structural equations has been used. For determining Tool Reliability, Cronbach Alpha coefficient has been used. So as that Cronbach Alpha coefficient for all research variables that are above 0.8, and the value of “0.836” of KMO and Croit Bartlet Test, on a significant level of “0.99%” has been rejected, and this is an indication of Tool Validity and Reliability. Questionnaire structure and Cronbach Alpha for measurement of questionnaire reliability was shown in table1.

Table 1: Questionnaire structure and Cronbach Alpha for measurement of questionnaire reliability

Questionnaire structure			Cronbach Alpha
concept	Dimension	Question number	-
socio–demographic	-	1-5	-
Corporate citizenship (CC)	Economic Citizenship	6-14	0.8324
	Legal Citizenship	15-22	0.7984
	Ethical Citizenship	23-29	0.8321
	Volunteer Citizenship	30-36	0.8012
Behavioral factors	Social accountability	37-44	0.8174
	Social responsibility	45-50	0.7861
	Corporate governance	51-54	0.7962
Structural factors	Corporate structure	55-59	0.8241
	Corporate size	60-62	0.8142
	Corporate culture	63-68	0.8324
	Organizational capacity	69-72	0.8621
Contextual Variable	Viewpoint of corporate' manager	73-81	0.8124
	Viewpoint of corporate' clientele	82-86	0.7984

In the current study, Descriptive Statistics and Inferential Statistics have been used in analyzing compiled data by the questionnaires. So as that in Descriptive Statistics, frequency of given answers to the indices and to the dimensions of Corporate Citizenship Behaviors along their averages, is used for determining those units in which Corporate Citizenship Behavior is high or Low. Then the given results to indices which are related to Structural, behavioral and underlying factors, are presented in Table format, which in turn is classified according to High or Low units of Corporate Citizenship behavior.

For determining the influence of each of The Three factors (triple factors), effective on the development of Corporate Citizenship Behavior, in inferential statistics (considering that the questionnaire meter is a rating scale) we use Mann-Whitney U test which is nonparametric.

By performing this test and drawing a comparison between two groups of under examination Units(units in which Corporate Citizenship Behaviors are high and those units in which Corporate Citizenship Behaviors are low) we have answered the research questions in terms of : Social responsibility , social accountability, corporate governance , corporate size, the organizational structure type of the corporate, the type of organizational culture, organizational capacity , viewpoints of directors and clientele to the function of corporate Morality .

In the next part, the relationship between corporate citizenship and its dimensions with constitutive component of triple factors effective on the corporate citizenship behavior development, for additional information is going to be surveyed.

FOR THIS PURPOSE, CONSIDERING THAT VALUE MEASUREMENT SCALE OF THIS RESEARCH IS A RATING SCALE, WE USE SPEARMAN'S RANK CORRELATION COEFFICIENT. AFTER THE IDENTIFICATION OF THE CURRENT STATE OF CORPORATE CITIZENSHIP AND EFFECTIVE FACTORS ON IT, IN THE UNDER SURVEY CORPORATIONS, THE PATH FROM THE CURRENT CONDITIONS TOWARDS MORE DESIRABLE CONDITIONS IS MAPPED OUT.

5- Data Analysis

In this part of research, the analysis of data has been done, in descriptive method and analytic method according to answers to the research questions.

The results of Descriptive statistical based of socio–demographic indicates that among 50 companies (55 percentage belongs to and petrochemical industry and 45 percentage belongs to Food clothing industry). 85 percentage of replier was man. Based on age 25% of replier were 28-35 years, 48 % between 35-50 years and 27% were up 50 years. Also 51 % were graduated, 35% were diploma and 14% of replier have master and doctoral education.

(A)-the results of the description of the main research variables

First question: how is the condition of corporate Citizenship of Iranian production corporate active in industrial Units?

According to compiled data from questionnaire, the average of the answers of actuarial samples to the representing factors of corporate citizenship behavior are as the Table (2) for the under-survey Units:

Table 2: The rating average of answers submitted by the representing factors of corporate citizenship behavior according to the under-survey Units:

Corporate citizenship condition	Corporate citizenship	Citizen volunteer	Ethical citizen	Legal citizenship	Economic citizenship	Corporate's number
High Corporate citizenship	3.2855	3.2451	3.3451	3.2415	3.3104	21
Low Corporate citizenship	2.8380	2.7412	3.0415	2.6781	2.8921	29

According to table number(1), it can be inferred that 21 corporation, equivalent to 43% of under survey corporate, have a higher Corporate citizenship behavior than the average medium(3.2855) and 29 other corporate ,namely the left 57 % ,have a lower Corporate citizenship behavior than the average (2.8380).according to above record it can be also inferred that both of these two groups have had higher rates than the average in the Ethical citizenship part , but in the other dimensions the second corporate have had lower rates than the average.

Second question: to what extent do structural variables affect the corporate Citizenship of Iranian Production corporate active in industrial units?

Totally, the average of represented answers to the elements of Behavioral factors in units with different corporate citizenship behavior can be summarized as the following Table Number (3):

Table 3: the Average of those scores which are related to Behavioral factors of the underlying study Units

concept	dimensions	Low corporate citizenship	High corporate citizenship
Behavioral factors	Social responsibility	3.3722	3.9182
	Social accountability	3.1833	3.7182
	Corporate governance	3.0278	3.75

According to the represented data in the table, it can be noted that in the both of the surveyed corporate, dimensions representing behavioral factors - including Social responsibility, Social accountability, corporate governance, and corporate governance - are higher than the medium. But in all the three dimensions, the obtained average for those corporate that their Corporate Citizenship behavior is high is more than those corporate that have a lower Corporate Citizenship behavior.

Third question: to what extent do behavioral variables affect the corporate Citizenship of Iranian Production corporate active in industrial units?

Totally, the average of represented answers to the elements of Behavioral factors in units with different corporate citizenship behavior can be summarized as the following Table Number (4):

Table 4: the Average of those scores which are related to Behavioral factors of the underlying study Units

conception	Dimensions	low corporate citizenship	High corporate citizenship	elements
Structural factors	structure	2.3577	3.2475	organic
		3.2451	2.5471	mechanic
	size	3.0214	3.1121	large
		2.9571	3.2415	medium
		3.1147	3.0144	small
	culture	3.0112	3.3571	Market-oriented approach
		3.1145	3.6124	Human-centered approach
		3.3245	2.9847	Competitive attitude
	Organizational capacity	3.0321	3.3257	high
		3.2141	2.9132	low

According to the offered data at the above table, it is noted that in those corporate with high corporate citizenship behavior, the type of organic structure, having medium size, having human-centered approach and a high organizational capacity, have allocated the highest average to themselves. But at those corporate with a low corporate citizenship behavior, mechanical structure, small size, competitive attitude and low organizational capacity, have the highest average.

Fourth question: to what extent does underlying variables affect the corporate Citizenship of Iranian Production corporate active in industrial units?

Totally, the average of represented answers to the elements of contextual factors in units with different corporate citizenship behavior can be summarized as the following Table Number (5):

Table 5: the Average of those scores which are related to Behavioral factors of the underlying study Units

concept	Dimensions	Low corporate citizenship	High corporate citizenship
Contextual factors	Directors' viewpoint to corporate ethical behavior	3.2471	3.9621
	Clientele's viewpoint to corporate ethical behavior	2.6751	3.1784

According to the presented data at the above table, it can be noted that in the both of the surveyed corporate with either high or low corporate citizenship, Directors of corporate held a positive view to the ethical function of corporate. But the obtained average for the first group is more than the second group. But the notable point regarding viewpoints of clientele towards corporate ethical behavior is that this matter is different for them(for clientele) .so as that the average of positive viewpoints of clientele towards the ethical behavior of first group (that their corporate citizenship is higher) are more than the medium ,while the average of positive viewpoints of the same clientele towards the ethical behavior of second group(that their corporate citizenship is lower) are below the medium.

Answering the fifth question will be postponed to the aftermath of Data analysis.

B- The Results of Data Analysis

1) The analysis of the effects of behavioral factors on corporate citizenship

For having information on existence of Correlation between behavioral factors and corporate citizenship behavior of under survey corporate, **Pearson correlation coefficient** is calculated in regard to the fact that represented Data are Normal.

Table 6: correlation between behavioral factors and corporate citizenship behavior

corporate citizenship behavior	behavioral factors
ρ = 0.622**	Pearson correlation coefficient
0.000	The probability
169	number
Source: research Data	

As it is visible, there is a significant relationship between behavioral factors and corporate citizenship behavior on the level of double star and its Pearson correlation coefficient is 62%. After surveying Model Adequacy Indicators that is shown in the following table, for survey and representation of the relationship model between corporate citizenship behavior(Y) and behavioral factors(X), the study is dedicated to representation of THE Analyzed model.

Table 7: Model Adequacy Indicators between behavioral factors and corporate citizenship behavior

Statistical distance-Watson	Standard deviation of error	Adjusted coefficient of determination	The coefficient of determination	correlation
1.882	**0.488**	**0.384**	**0.386**	**0.622**
Source: research Data				

The calculated coefficient of determination is 0.38 .and this quantity indicated that 38% of all changes in corporate citizenship behavior is related to their behavioral factors and the other 62% are contingent on other element and factors.

Table 8: Regression model of behavioral factors and corporate citizenship behavior						
Model		Non-standard coefficients		Standardized coefficients	*t*	*Sig.*
		B	*Std. Error*	*Beta*		
1	Constant value(fixed value)	0.803	0.183		4.38	0.000
	Behavioral factors	0.759	0.60	0.622	12.574	0.000
a : variable dependent on corporate citizenship behavior						
Source: research Data						

The input variable in Regression equation is main kernel of Regression analysis that is represented in table number (7).using the column (B), Regression equation can be calculated as the following account:

$$P= 0.803+ 0.759\ Q + \acute{\varepsilon}$$

Corporate citizenship behavior = 0.803+0.759 behavioral factors + Error

In other words, promotion of one unit of behavioral factors 0.759 will be followed by promotion of corporate citizenship behavior.

(t) Test which is related to Regression coefficient also shows that this coefficient is significant (sig = 0.000) and is influential on the estimation of corporate citizenship behavior value.

Multiple Regression model with step by step methodology is used for surveying the effectiveness of each of behavioral factors on the corporate citizenship behavior. Results are represented in the following Table number (9).

Table 9: Multiple Regression model of effective behavioral factors effective on the corporate citizenship behavior. Using step by step methodology						
Model		Non-Standardized coefficients		Standardized coefficients	*t*	*Sig.*
		B	*Std. Error*	*Beta*		
1	**Constant value**	1.453	0.135	-	10.802	0.000
	Q_3	0.569	0.046	0.616	12.399	0.000
2	**Constant value**	1.381	0.15	-	7.886	0.000
	Q_3	0.544	0.052	0.567	7.674	0.000
	Q_1	0.209	0.052	0.312	3.766	0.000
3	**Constant value**	1.252	0.157	-	7.235	0.000
	Q_3	0.531	0.061	0.528	7.24	0.000
	Q_1	0.201	0.065	0.227	6.81	0.000
	Q_2	0.153	0.043	0.132	3.129	0.017
a : variable dependent on corporate citizenship behavior						
Source: research Data						

According to the (B) values of Table number 8, the Regression equation can be written as followings:

$$P= 1.252+ 0.531Q3 + 0.201\ Q1 + 0.153\ Q2$$

But, judgment about contribution and role of each of these two variable, social responsibility (Q3) and corporate governance (Q1), in determination of the dependent variable must be assigned to Beta Values. Because these values are standardized and they can provide the possibility of comparison and determining the relative contributions of each of the variables (Kalantery 1387:188). According to B value social responsibility coefficient (Q3=0.53) is far away higher than value of corporate governance (Q1).The value of their Beta also implies that Q1 has less roles and contributions than Q3.Because according to the achieved Beta per every unit of variation (change) in social responsibility, a value of 0.528 will be created in Standard deviation of corporate citizenship behavior. While per every unit of variation in corporate' governance, only a value of 0.227 will be created in Standard deviation of corporate citizenship behavior.

2- Analysis if effects of structural factors on corporate citizenship behavior.

For significance of variation of structural dimension (mechanic or organic) and organizational capacity (high or low) as a dimension of structural factors' content, Mann- Whitney Test is used. And For significance of variation of the other two dimensions of structural factors' content including corporate' size and corporate' culture for two under survey corporate, kruskal wallis' Test ,is used. In the following Table, the average of resulted rates for structural factors' variables is represented.

Table 10: the average of structural factors' rate according to Units Type

Rate average	number	Corporate citizenship behavior type			
75.35	21	High CC	Mechanical structure	Organizational structure	Structural dimension
84.32	29	low CC			
91.32	21	High CC	Organically structure		
84.36	29	low CC			
81.32	21	High CC	small		Dimensions of content
80.36	29	low CC			
86.35	21	High CC	medium		
79.32	29	low CC			
81.54	21	High CC	large		
81.21	29	low CC			
85.63	21	High CC	Market oriented		
82.32	29	low CC			
86.32	21	High CC	Human centered		
81.24	29	low CC			
89.36	21	High CC	competitive		
82.32	29	low CC			
86.35	21	High CC	high		
81.93	29	low CC			
79.65	21	High CC	low		
82.01	29	low CC			

According the above table, the following results are deductible:

1-according to structural dimension of structural factors, it can be inferred that the average of Corporate citizenship behavior in those corporate that their organizational structure are organic is higher than Corporate citizenship behavior of those corporate whose organizational structures are mechanic

2-in regard to dimensions of content according to size, it can be inferred that corporate citizenship behavior is higher in those corporate that are medium in size.

3 in regard to dimensions of content according to culture, it can be inferred that Corporate citizenship behavior is higher in those corporate that are human-centered in orientation.

4. In regard to dimensions of content according to capacity, it can be inferred that corporate citizenship behavior is higher in those corporate that are higher in organizational capacity.

As it was mentioned ,for significance of effectiveness of structural factors on Corporate citizenship behavior ,two tests of **Mann-Whitney** and **Kruskal Willis** is used , and the results are according to Table Number (11) and Number(12):

Table 11: the results **of Mann-Whitney test,** for surveying the significance of structural dimension's variations and for surveying one of Dimensions of content (organizational structure) in two under survey groups.

Table 11: the results of Mann-Whitney test

	Organizational capacity	Structural dimension
Mann – Whitney Test	635.5	580.5
Wilcoxon rank sum test	1670.5	1615
Z	-04.002	- 4.6
Significance	0.000	0.000

According to Table Number (11), since the level of significance of Mann-Whitney test, is lesser than 5%, it can be inferred that the variation between Dimensions of structural dimension and one of the dimensions of contents of the two under survey groups of units, is significant from an actuarial perspective. So, corporate citizenship behavior is different in corporate with different organizational Structures and capacities

Table Number (12): the results of Kruskal Wallis for surveying Significance of variation of two dimension of content of Size and Culture in two under survey Units

Corporate culture	Corporate size	
18.632	17.351	Square k
2	2	Degrees of freedom
0.000	0.000	Significance level

Since, According to Table number (12), the significance level of **Kruskal Wallis** is lesser than 5 percent it can be concluded that the variation of corporate size and corporate culture of the two under survey groups, are significant from an actuarial aspect. So that the corporate citizenship is various incorporates with different Size and culture.

3- Analysis of Contextual factors on corporate citizenship behavior

For having information on existence of Correlation between contextual factors and corporate citizenship behavior of the under survey corporate, **Pearson correlation coefficient,** is calculated in regard to the fact that represented Data are Normal.

Table 13: Correlation between Contextual Factors and corporate citizenship behavior

corporate citizenship behavior	Contextual Factors
ρ = 0.375**	Pearson correlation coefficient
0.000	The probability
169	Number
Source: research data	

As it is visible, there is a significant relationship between contextual factors and corporate citizenship behavior on the level of double star and its Pearson correlation coefficient is 37.5%. For survey and representation of the relationship model between corporate citizenship behavior(Y) and contextual factors(X), the study is dedicated to representation of the analyzed model.

Table 14: Model Adequacy Indicators between contextual factors and corporate citizenship behavior

Statistical distance-Watson	Standard deviation of error	Adjusted coefficient of determination	The coefficient of determination	**correlation**
1.761	0.341	0.1396	0.1406	0.375
Source: research Data				

The calculated coefficient of determination is 0.14 .and this quantity indicated that 14% of all changes in corporate citizenship behavior is related to their contextual factors and the other 86% are contingent on other element and factors.

Table 15: Regression model of contextual factors and corporate citizenship behavior						
model		Non-standard coefficients		Standardized coefficients	*t*	*Sig*
		B	*Std. Error*	*Beta*		
1	Constant value (fixed value)	0.614	0.178		4.412	0.000
	contextual factors	0.321	0.54	0.411	13.044	0.000
a : variable dependent on corporate citizenship behavior						
Source: research Data						

Using the column (B), Regression equation can be calculated as the following account:

$$P= 0.614 + 0.321\ Q + \acute{\varepsilon}$$

Corporate citizenship behavior = 0.614 + 0.321 contextual factors + Error

In other words, promotion of one unit of contextual factors 0.321 will be followed by promotion of corporate citizenship behavior.

(t) Test which is related to Regression coefficient also shows that this coefficient is significant (sig = 0.000) and is influential on the estimation of corporate citizenship behavior value.

Multiple Regression model with step by step methodology is used for surveying the effectiveness of each of contextual factors on the corporate citizenship behavior.

Results are represented in the following Table number (16)

Table 16: Multiple Regression model of effective contextual factors effective on the corporate citizenship behavior. Using step by step methodology						
Model		Non-Standardized coefficients		Standardized coefficients	*t*	*Sig.*
		B	*Std. Error*	*Beta*		
1	**Constant value**	1.23	0.147	-	11.632	0.000
	Q_1	0.124	0.035	0.175	7.6319	0.000
2	**Constant value**	1.412	0174	-	3.624	0.000
	Q_2	0.541	0.059	0.621	11.2321	0.000
	Q_1	0.112	0.151	0.139	7.621	0.000
a : variable dependent on corporate citizenship behavior						
Source :research data						

According to the B values of Table 16, the Regression equation can be written as followings:

$$P = 1.412 + 0.541\ Q2 + 0.112\ Q1 + \acute{\varepsilon}$$

judgment about contribution and role of each of these two variable , Q1(directors' viewpoint towards Corporate citizenship behavior) and Q2 (clientele's viewpoint towards Corporate citizenship behavior),in determination of the dependent variable must be assigned to Beta Values .According to B value, coefficient of clientele's viewpoint towards Corporate citizenship behavior is far away higher than coefficient of directors' viewpoint towards Corporate citizenship behavior .

The value of their Beta also implies that Q2 has more roles and contributions than Q1. Because according to the achieved Beta per one unit of variation(change)in clientele's viewpoint towards Corporate citizenship behavior , a value of 0.541 will be created in Standard deviation of corporate citizenship behavior. While per one unit of variation in directors' viewpoint towards corporate citizenship behavior, only the value of 0.112 will be created in Standard deviation of corporate citizenship behavior.

Fifth question:

Based on what ground and plan can a corporate move from the current condition towards a more desirable condition?

The results achieved from this survey proved that the under survey corporate are not in a good condition in terms of having Corporate citizenship characteristics .so, it is necessary that they should move toward a more favorable condition with taking new strategies , new organizational structures , and some new changes in their goals .in other words , corporate should promote their social responsibility, social accountability, and corporate governance through setting new methodologies as their lead. Using organic structures ,putting Human centered orientation as their organizational culture, organizational capacity, keeping the corporate size at a medium level, are other instances that corporate are holding to in their strive to gain corporate citizenship.

Corporate promote their corporate citizenship by creation and development of social capital and increasing clientele's trust and confidence to themselves and dominating clientele's positive viewpoints

6-Discussion and conclusion

The results of this study proved that under survey producing corporate, are not in a desirable condition of corporate citizenship behavior. So that, according to the opinions of Directors' board, in the past years the average of citizenship factors have been lesser than usual from a legal, economical, ethical and voluntarily perspective. by considering the current crises of the nation that are mostly caused by economical sanctions , Producing Units haven't been able to reach their commercial and economical goals. On this account, corporate have sometimes behaved outside of the legal framework to strive in the market. In some cases they have ignored or violated the laws or even they have abused the laws in favor of themselves. Naturally the present situation of market has made them to overlook what formerly had been their ethical principle. On the other hand, involvement of corporate with their own problems has made them to try to make the current conditions steady, instead of doing voluntarily works including helping charity institutions.

Several factors have been involved in relation to the current state .one of these is behavioral factors, in a way that low commitment of corporate to their own social responsibilities to individuals has decreased their corporate citizenship level. in a manner that , not feeling responsibility toward providing society's demands, inconsistency between society's goals and corporate' goals, not caring about providing clientele's demands, ignorance to improvement of life of people, and ignorance to the ruling culture and canon of a society ,has made this issue worse. structural factors is one of other effective factors on the undesirable condition of corporate citizenship behavior of The under study Units .predominance of mechanical structural, predominance of market-oriented culture and low organizational capacity, as the most important structural indicators have made these corporate disable to do their own citizenship duties in relation to society's individuals, yet they have been ignorant in dealing with it. finally clientele's negative viewpoints towards corporate , and low level of social capital of corporate among society's individuals has made clientele lose their faith in these corporate and has made them to take into regard the presented ethical principles by those corporate with some unbelief and incredulity .

According to what was mentioned, corporate must make some fundamental changes in their strategy, goals and organizational structures in order to gain access to corporate citizenship behavior and to gain other advantages of these behaviors.

They must developed their social responsibility, social accountability and corporate governance among its employees as the most important strategies of corporate that could be their citizenship duties toward society's individuals. And they may use hortatory methods and even sometimes use punishment as a way to commute their employees to those values in different producing units.

Through improving the body of Expert boards, and using appropriate equipment and information technology, meantime that organic structure in the proportion of organizational capacity will be prevailed by presenting needed training, one can also stress the importance of necessity of respect to humane dignity through setting human centered orientation instead of market oriented cultures and through bringing Ethical principles to foreground, as well.

On the other hand corporate must be in think of improving their social capital through setting up powerful communicable nets and through exercising their commitments toward society's individuals.

In short, corporates' directors must have faith in commitment to society's ethical principles and ruling canon, and for short terms benefits do not act as a way that clientele loss their trust in them so that they behave those corporate with an inappropriate citizenship behavior, and even it may cause Society not to admit those corporate as its Citizens.

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The Growth of Islamic Financial and Capital Markets

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Abstract

The growth in Islamic financial and capital markets over the last 40 plus years since inception can be described as nothing short of remarkable. It has expanded beyond banking to insurance (*Takaful*) and into capital markets (debt, equity and derivatives). Islamic financial markets demand Shari'ah compliance and much of that compliance has come from real product innovation based on historic Islamic contract forms and combinations thereof. These have embraced the idea of the larger objective of Shari'ah which is to benefit the long term good of society. Islamic debt, called Sukuk has been far and away the star of the show in terms of market leadership and growth. While described as an Islamic debt there are key elements of Sukuk that differ from conventional fixed income investments and that determine Shari'ah compliance. There is also controversy regarding the terms of some Sukuk that impairs, in the mind of some scholars, the true level of Shari'ah compliance. There is also a general feeling that in order to meet the full objectives of a Shari'ah way of life that Islamic finance needs to move away from mere technical compliance. Indeed the 2008 global financial crisis has indicated the potential benefits of moving away from debt-based economies. This has created an opportunity for Islamic finance to step into the breach and promote a more equity-based system. In order to explore the potential, this paper will examine initial listing requirements of the TMX versus the Bursa Malaysia (MYX) in order to understand the potential for Islamic equity-based financings. We will further compare the approach of the two exchanges related to their Shari'ah indices. The research and comparative analysis has determined that there is indeed much further that can be done to expand the depth and diversification of Islamic capital markets and indices that will promote sustainable growth in the Islamic equity markets.

Growth of Islamic Finance

The Malaysia International Islamic Finance Centre (MIFC), in a presentation at the ASEAN Capital Market CEO Summit in Kuala Lumpur in February of 2015, identified that Islamic global finance assets had reached USD 2 trillion by the end of 2014[i]. The MIFC further predicted that Islamic financial assets would continue to grow exponentially and are predicted to surpass USD 3 trillion by the year 2018[ii]. Certainly this growth can only be viewed as extraordinary.

This is particularly true given the historical emergence of Islamic finance from a virtual zero base in the mid 1970's to its current position.

The genesis of growth largely began with the significant rise in oil prices at that time and the wealth conveyed to Arab and Muslim nations as a result. Real growth in economic and investment activity followed and with it, demand for investments and financing approaches consistent with Shari'ah principles. The table below outlines the real growth in Islamic financial services since inception from the perspective of participating geographies, products and institutions[iii]. The growth in breadth and depth of the market is really quite a remarkable global phenomenon as evidenced by the table below.

Interestingly international financial centres like London and New York have recognized and have begun to serve the market demand for Islamic financial product.

Stages of evolution of the Islamic financial services industry

	1970's	1980's	1990's	2000's	2010's
Institutions	Commercial Islamic banks	Commercial Islamic banks	Commercial Islamic banks	Commercial Islamic banks	Commercial Islamic banks
		Takaful	Takaful	Takaful	Takaful
		Islamic Investment Co's	Islamic Investment Co's	Islamic Investment Co's	Islamic Investment Co's
			Islamic Investment Banks	Islamic Investment Banks	Islamic Investment Banks
			Asset Managers	Asset Managers	Asset Managers
			Broker Dealers	e-Commerce	e-Commerce
				Broker Dealers	Broker Dealers
Products	Islamic Banking Products	Islamic Banking Products	Islamic Banking Products	Islamic Banking Products	Islamic Banking Products
		Takaful	Mutual Funds/Unit Trusts	Mutual Funds/Unit Trusts	Mutual Funds/Unit Trusts
			Islamic Bonds	Islamic Bonds	Islamic Bonds
			Shari'ah Compliant Equities	Shari'ah Compliant Equities	Shari'ah Compliant Equities
			Islamic Stockbroking	Islamic Stockbroking	Islamic Stockbroking
				REIT's	ETF's
					REIT's
Area	Gulf/Middle East	Gulf/Middle East	Gulf/Middle East	Gulf/Middle East	Gulf/Middle East
		Asia/Pacidic	Asia/Pacidic	Asia/Pacidic	Asia/Pacidic
				Europe America	Europe America
				Global Offshore Market	Global Offshore Market

Shari'ah Compliant Product

Much of the growth indicated above can be attributed to product engineering and innovation. It's worthwhile to spend some time examining the degree of innovation that has existed in the development of *Shari'ah* compliant products and services that have fueled much of this growth. *Shari'ah* literally means "the way to the source" and represents the set of customs, values and laws leading to an Islamic way of life. For Islamic finance this means economic transactions must be designed not only to be legal or functionally compliant but also moral and ethical too. They should promote *maslahah*, or the larger public good. Commercial transactions need to embrace issues of equity, fairness, practicality and social justice in order to meet a Shari'ah standard.

In general, unless something is clearly forbidden (*haram*), it will be allowable (*halal*) – again given that it also meets the standard of being ethical and moral as well. Islam is very clear in regard to the fundamental commercial activities that are prohibited. These include:

- Prohibition of *Riba* or interest payments – which represents the excess growth in a debt repayment above the original capital amount. In Islam money is not an asset that can of itself generate real economic growth. The prohibition of *Riba* in general restricts the provision of conventional finance and insurance services as we know them in the west.
- Prohibition of *Gharar* or risk – which represents the uncertainty resulting from ambiguity or deception. The amount or element of *gharar* in a transaction will determine the legitimacy of the deal.
- Prohibition of *Maysir* or gambling – which represents a transaction usually between two parties where ones gain is the others loss. Islam views this as an activity that distracts away from productive activities and is an attempt to accumulate wealth without effort.
- Other Prohibited activities include drinking alcohol, eating pork and partaking in other immoral activities like pornography and prostitution. Any commercial enterprise involved in producing, marketing, supplying or selling these services is not permitted.

Given the prohibition of *Riba* in particular, and recognizing the prominence of debt/fixed income financing in the capital structures of firms and financial markets in western economies, financial product innovation has been the most critical element in driving Islamic finance forward. Shari'ah compliant products that mirror conventional finance products (equity, debt and derivatives) have been devised through the adoption of contract structures consistent with the rules and conditions necessary for legitimacy in an Islamic context. Many of these contract types are historic and draw their legitimacy directly from the *Qur'an.* For equity financing the two main contracts types are *Mudarabah* or profit sharing arrangement; and *Musharakah* which is a profit and loss sharing arrangement. These are outlined briefly below:

Mudarabah **–** is a contract that brings together an entrepreneur (*mudarib*) and a financier (*rabbul mal*) whose role is solely limited to providing capital for the venture. The financier will participate, to an agreed level, in the success of the venture but solely bears the loss if the venture is not sound. Shari'ah compliance demands that there be no assured return of capital to the capital provider. For clarity financial intermediation is legitimate for *Mudarabah*. It is allowable for a third party to bring entrepreneurs and financiers together.

Musharakah **–** is a contract where both parties, the financier and the entrepreneur, contribute capital, labour, property, expertise, etc. into a joint venture arrangement. The parties, dependent on the nature and degree of their contributions, will share in the risks and the rewards of the endeavor as agreed in advance. Given number of potential combinations of resource contribution amongst the parties, it's not surprising that there are a number of legitimate forms of *Musharakah*.

Because conventional debt is interest-based or reliant on *Riba* it cannot be considered to be a *Shari'ah* compliant form of financing. *Riba* is viewed as a further form of wealth transfer from the poor to the rich and therefore highly unjust.

To address this issue the Islamic equivalent of debt financing is structured on the basis of underlying contracts such as a purchase and sale agreements or *Murabahah*.

Murabahah **–** is a purchase and sale agreement where the entrepreneur purchases a real asset from a financial institution who has acquired it on his behalf. The price will include the cost and a disclosed mark-up or profit component. Payment will occur in the future either on a lump sum basis or via instalments. For legitimacy it is essential that the *Murabahah* contract cannot lead to *Riba*.

There are many forms of sale based contracts including *Salam* (forward sale), *Dayn* (sale of debt), *Inah* (sale buyback), *Sarf* (sale of currency), *Musawamah* (bargaining sale), *Tawliyah*/*Amanah* (trust sale), *Muajjal* (deferred payment) sale amongst others and combinations of all of these.

Two other important forms; *Istisna* (manufacturing sale) and *Ijarah* (Leasing) are outlined briefly below:

Istisna **–** is a purchase order contract, usually with a manufacturer who will construct a product to specification for a future payment including a mark-up that can also be made in instalments or as agreed amongst the parties to the contract.

Ijarah – is a lease financing arrangement typically used to finance an asset or a piece of capital equipment. The lease payments will pay for the use of the asset over some part or all of the assets useful life. In certain types of *Ijarah* the asset can be transferred to the lessee through a purchase and sale agreement at the end of the contract.

These contracts or combinations of them underpin the basis for the majority of Islamic securities. The most important and successful of these is the Sukuk.

Sukuk

The Sukuk market has been the fastest growing and the most dominant component of Islamic finance and capital markets. This is not surprising as Sukuk are designed to deliver low risk, provide a fixed investment return and to be Shari'ah compliant.

According to Malaysia Debt Securities, Sukuk are defined as *"certificates of equal value that represent an undivided interest (proportional to the investor's interest) in the ownership of an underlying asset (both tangible and intangible), usufruct, services or investments in particular projects or special investment activities.*[iv]*"*

Most often Sukuk are compared to conventional bonds in that they are designed to provide a fixed return over time. Like a bond, Sukuk can be sold in the secondary market for cash and are ranked by financial institutions using similar criteria used to rank bonds. Of course conventional bonds are prohibited in the Islamic financial system because of the interest-based return and the money for money concept that is fundamental to their make-up. Sukuk on the other hand, were developed based on Shari'ah principles using forms of the equity and sale-based contracts described above. The intent is that they're constructed to be halal. In so doing, there are five fundamental differences between conventional bonds and Sukuk that essential for Shari'ah compliance[v]. These are summarized in the table below.

Conventional Bonds	Sukuk
Represent a debt obligation	Represent ownership of an asset
There may be no recourse to assets back bonds and if there are they may not be Shari'ah compliant	Assets backing the Sukuk are Shari'ah compliant
Bond pricing impacted by your credit rating	Sukuk are priced to the value of the underlying assets used as backing (i.e. based on the profits of the assets or enterprise)
Profit from bonds will be based on prevailing interest rates, the bond features (i.e. if their callable) and the term remaining	Sukuk can increase in value when the underlying assets or prospects increase in value
When a bond is sold it represents a sale of debt	When you sell a Sukuk you're selling your proportionate ownership in the underlying assets that are backing the Sukuk

The end result of these differences is that the Sukuk holder has acquired an asset, that in and of itself is compliant with Shari'ah and has inherent value that may grow over time.

Despite this, many Sukuk structures have come under criticism from conservative scholars who question the validity of Shari'ah compliance given the characteristics of their design. The criticism is that through sophisticated financial product engineering, using combinations of the contracts listed above, Sukuk are constructed to provide investors with a return that is solely comprised of a fixed percentage of the principal (guaranteed through a form of liquidity facility) and certainty of return of principal (via guaranteed purchase undertakings) at maturity. In 2007, Sheik Taqi Usmani, then Chairman of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) suggested that mechanisms used in Sukuk today, "*strike at the foundations of these objectives and render the Sukuk exactly the same as conventional bonds in terms of their economic results.*[vi]*,* based on the liquidity and purchase option features employed. These criticisms appear to be justified and given the commercial considerations and the market demand, difficult to solve.

Issuers of Sukuk typically prefer a debt like approach in order to optimize their capital structure and Sukuk investors typically do not want to take on the asset and business risks consistent with an equity investment. Many regimes also provide more advantageous tax treatment terms for debt that complicate or suppress an issuer's ability to maintain Shari'ah compliance whilst still successfully marketing the issue. Certainly financial markets actively price Sukuk issues in the same way they price conventional fixed income products. That is the pricing is based on the term to maturity, rate of return, riskiness of the issuer (i.e. sovereign entity, corporate, etc.) and liquidity. In the face of default, asset-backed Sukuk investors have been shown to enjoy the security of the underlying asset backing the arrangement. This tends to re-affirms the Shari'ah compliance of the Sukuk although this has not been tested or confirmed for asset-based structures.

Despite the controversies and questions regarding Shari'ah compliance, Sukuk has grown exponentially in value and volume in the financial market place.

Sukuk Role in Islamic Financial Markets

Malaysia dominates overall Sukuk issuance globally. Reportedly, since inception and until 2014, Malaysia has become the largest sukuk market, holding approximately two-thirds of outstanding global sukuk[vii] representing greater than RM 600 billion. Indeed while many Sukuk issuers are sovereign entities, Malaysia has issued corporate Sukuk that is denominated in Ringgit as well as U.S. dollars. These issues are sold globally including in to the large capital markets in Europe and the United States. For example in 2015, the Government of Malaysia issued a U.S. $1.5B Sukuk with one tranche $1B having a 10 year term and the second tranche 30 years. Fully 26% of the 10 year and 48 % of the 30 year was issued to European and United States investors.[viii]

Growth in Malaysia is supported by a robust legal and regulatory framework engendered by a long and consistent history of support for Islamic finance and growth of their capital markets. In addition to implementing frameworks and policies designed to foster growth in the Islamic capital markets, Malaysia has also undertaken real concrete measures like amending their tax code to introduce tax neutrality. This has further stimulated and supported development and growth which has led to their dominance in Islamic capital markets – in particular when it comes to Sukuk. Not only does Malaysia provide a template or model for other Muslim jurisdictions to follow, its clear indication that with the right focus and regulatory determination, markets can be nurtured and established.

State of Islamic finance

As outlined in the previous section, Islamic capital markets have undergone spectacular growth. The question for those who have followed this growth is whether has or is achieving the ends or *maqasid* of Islamic banking and finance which is to promote a system of life consistent with the morals of Islam.

"For Islamic economics, banking and finance, the objectives, among others, would include the circulation of wealth in society, advocating fair and transparent financial practices and promoting socio-economic justice"[ix]

In this sense it is important that Shari'ah not be reduced to mere legal compliance. That is to say, Islamic finance needs to ensure that it promotes the *maqasid* of Shari'ah, which is maximizing human life and wellbeing, as opposed to simply pursuing technical compliance.

The recent global financial crisis in 2008 does provide some lessons for Islamic finance in this regard.

Lessons from the Financial Crisis

The global financial crisis of 2008 is widely viewed as the most severe since the Great Depression. The genesis of the crisis was the issuance of sub-prime mortgages in the U.S. and reflected:

"easy money, uncontrolled growth of credit and debts, lax regulation and supervision, innovation of complex financial structures that far exceeded the real potential and needs of the economy, mismanagement of risks involved, lack of disclosure and transparency, predatory lending and high leveraging"[x]

There are a number of elements of interest here for Islamic finance. Firstly banks encouraged borrowers to incur more debt than they could handle, made imprudent and excessively risky loans and subsequently, through securitization, they were able to transfer or sell that risk to third parties. Secondly the degree of financial engineering and the product complexity created a situation where investors, issuers and regulators were unable to sufficiently understand the securitized investment products in order to properly assess and price risk.

These critical elements of lending behaviour that led to the financial crisis would not have been allowed under Islamic finance rules. They do not reflect Shari'ah compliant practices and not just because of the debt accumulation and use of *Riba*, but also because the behaviour exhibits excessive *Maysir* and *Gharar* as well.

More broadly there has been a renewal in the "financial instability hypothesis" as conceived by Hyman Minsky[xi], who suggested that it is precisely economic stability and low interest rates environments that encourage the excessive debt that leads to long-run instability and eventually to a crisis. Each new crisis is borne of the stability and optimism of the period that precedes it.

If you accept this hypothesis, the natural conclusion is to reconsider the debt-based international and financial economic systems and to move towards equity-based financing as the primary basis for commerce. This in essence would be moving towards a more Islamic based financial system.

From a global perspective, this would represent a huge undertaking; one that if successful would see the world embracing a more Islamic way of being, where debt is not predominant and utilized only where and when necessary

If this is to be, Islamic finance and capital markets must take the lead and so there is work to do. As established earlier although many Shari'ah compliant products have been designed to be *halal*, they have done so in a legal or technical way. Product innovation has been the primary thrust of development for Islamic finance and while this has led to spectacular growth and created a foundation for the industry, surely it needs to evolve beyond this stage. Islamic finance needs to grow to become a more equity-based system, one that the world can look to as a way of the future.

The question is then how to begin to make the changes and steer the course of the ship in that direction. The good news is that most Muslims believe that Profit and Loss sharing is fundamental to Islamic finance[xii] and so cooperation will be or should be encountered along the way.

In this next section, we'll try to understand the ways and means that exchanges, like the Bursa Malaysia (MYX), can help equity markets evolve and grow their prominence in the capital markets. The MYX was chosen as a relatively well developed Islamic financial market. This will be done by examining and contrasting the MYX with the Toronto Stock Exchange or TMX Group Inc. (TMX). The comparison will be done from two perspectives; the first being from an original listing perspective. This examines the ways that companies can become public and gain access to public capital markets. It's clear that access to public financing and the liquidity provided by secondary market trading are critical to making equity financing a viable alternative for corporate entities. Secondly we'll examine and contrast the approach to creating Islamic indices on both the MYX and the TMX and try to understand the impact that this has on evolving towards a more equity-based financial system.

Role of Exchanges in Islamic Finance

Typically stock exchanges play an extremely important role in the development of developed economies. Exchanges provide vital financial intermediation role bringing capital providers together with entrepreneurs start new businesses and ventures, further capitalize growing ones and restructure those that are no longer or less viable than they once were. Exchanges are essential to the long viability of corporations, partnerships, industry sectors and economies. They play the following essential roles amongst others:

- Providing Access to Capital and Future Financing Opportunities
- Facilitating Growth
- Increasing the visibility and prestige of its listed entities
- Providing Liquidity to Shareholders
- Incenting Employees

Introduction to the Bursa Malaysia (MYX)

The Bursa Malaysia is a full service exchange, formerly the Kuala Lumpur Stock Exchange - named after the city in which it resides. It operates under the oversight of the Malaysia Securities Commission (SC) and offers a full range of trading alternatives including conventional bonds, equities, REIT's, ETF's, derivatives, Sukuk and other Islamic versions of these same securities. Through the facilities of its two primary markets: the Main Market with approximately 812 senior listed entities; and the ACE Market with over 100 issuers, the MYX facilitates financings across a diverse cross-section of sectors and products[xiii]. The Main Market provides listing services for established companies while the ACE market is sponsor-led and focused on companies exhibiting real growth potential. The classification of issuers, for both markets, as defined on MYX website is broken down as follows:

CLASSIFICATION OF APPLICANTS OR LISTED ISSUERS ON THE MYX

Sector Classified	Definition
Consumer Products	Companies manufacture materials or components into new products for consumer use
Construction	Companies engaged in constructing roads & railroads
Closed-End Funds	Close-ended investment entities
Exchange Traded Funds	Open-ended investment entities
Finance	Companies that provide services in activities of obtaining and redistributing funds and financial intermediation
Hotels	Companies that provide hospitality services in the form of accommodation, meals and drinks
Industrial Products	Companies manufacture materials or components into new products for industrial use
Infrastructure Project PLCs	Infrastructure project companies
Mining	Companies engage in exploration extraction, dressing and beneficiating of minerals
Plantations	Companies engage in the cultivation, planting and/or replanting of crops. The processing of agricultural products in factories on farms and plantations is also included if it is not feasible to report separately this activity from production of crops
Properties	Companies invest directly or indirectly in real estate through management or ownership
Real Estate Investment Trusts (REITs)	Real estate investment trusts or corporations
Special Purpose Acquisition Company	Special purpose acquisition companies
Trading/Services	Companies engage in distribution of products and provision of services other than financial services
Technology	Companies that provide information technology solutions

The Securities Commission (SC) sets out the original listing requirements in the Capital Markets and Services Act 2007 and they along with Bursa Malaysia are the regulatory bodies that control access to the market. Approval from the SC will come under Section 12 of the CMSA and will be focused on their equity guidelines, corporate governance and monitoring for conflicts of interest.

Listing on Bursa Malaysia

The quantitative criteria for listing on the MYX are summarized in the table below[xiv].

Bursa Malaysia Listing Requirements		
Criteria	**Main Market**	**ACE Market**
Mode of Listing	**Profit Test:**	
	Uninterrupted profit after tax ("PAT") of three to five full financial years ("FY"), with aggregate of at least RM20 million; and	No minimum track Record or Profit requirement
	PAT of at least RM6 million for the most recent full FY	
	Market Capitalisation Test	
	A total market capitalisation of at least RM500 million upon listing; and	
	Incorporated and generated operating revenue for at least one full FY prior to submission	
	Infrastructure Project Corporation Test	
	Must have the right to build and operate an infrastructure project in or outside Malaysia, with project costs of not less than RM500 million; and	
	The concession or licence for the infrastructure project has been awarded by a government or a state agency, in or outside Malaysia, with remaining concession or licence period of at least 15 years	
Public Spread	At least 25% of the Company's share capital; and a minimum of 1,000 public shareholders holding at least 100 shares	At least 25% of the Company's share capital; and a minimum of 200 public shareholders holding at least 100 shares
Bumiputera Requireme	Allocation of 50% of the public spread requirement to Bumiputera investors on best effort basis	No requirement on initial listing. Allocation on best effort basis of 12.5% of their enlarged issued and paid-up share capital to Bumiputera investors within 1 year of reaching Main Market or after 5 years on the ACE market.

Some important aspects of the listing criteria are worthy of mention. For a listing application to the MYX, where the resulting listing would be a group of companies, which is common in Malaysia, one of the group of companies must separately meet the minimum profit test, on its own.

If the listing is for an infrastructure project, then the listed entity must already have the right to build or operate the infrastructure on completion. Further qualitative listings requirements are provided below[xv]. The Bumiputera requirement represents a social objective of distributing what is deemed to a fair part of the offering to indigenous Malay peoples who were restricted from the time of British Rule. These rules are complicated and will require the expert advice of counsel.

Criteria	**Main Market**	**ACE Market**
Sponsorship	Not applicable	Engage a Sponsor to assess the suitability for listing Sponsorship is required for at least three years post listing
Core Business	An identifiable core business which it has majority ownership and management control Core business should not be holding of investment in other listed companies	Core business should not be holding of investment in other listed companies
Management Continuity and Capability	Continuity of substantially the same management for at least three full financial years prior to submission For market capitalisation test, since the commencement of operations (if less than three full financial years)	Continuity of substantially the same management for at least three full financial years prior to submission or since its incorporation (if less than three full financial years)
Financial Position & Liquidity	Sufficient level of working capital for at least 12 months; Positive cashflow from the operating activities for listing via profit test and market capitalisation test; and No accumulated losses based on its latest audited balance sheet as at the date of submission	Sufficient level of working capital for at least 12 months
Moratorium on Shares	Promoters' entire shareholdings for six months from the date of admission	Promoters' entire shareholdings for six months from the date of admission. Subsequently, at least 45% must be retained for another six months and thereafter, further sell down is allowed on a staggered basis over a period of three years
Transaction with Related Parties	Must be based on terms and conditions which are not unfavourable to the company All trade debts exceeding the normal credit period and all non-trade debts, owning by the interested persons to the company or its subsidiary companies must be fully settled prior to listing	Must be based on terms and conditions which are not unfavourable to the company All trade debts exceeding the normal credit period and all non-trade debts, owning by the interested persons to the company or its subsidiary companies must be fully settled prior to listing

It is interesting that while the Bursa Malaysia maintains an Islamic Market, there are no special initial listing requirements that link to Shari'ah compliance. Similarly no material mention of Shari'ah compliance is contained in the CMSA. According the MYX:

"The Shari'ah Advisory Council (SAC) of the Securities Commission Malaysia approves and updates shares classified as Shari'ah compliant Securities, listed on Bursa Malaysia. The list is updated twice a year.[xvi]*"*

The goals of providing the list of Shari'ah compliant entities[xvii] is set out on the Bursa Malaysia site in order to:

- *Facilitate investors seeking investment in Shari'ah compliant shares listed*
- *Centralisation of Shari'ah decisions domestically.*
- *Enhance disclosure and transparency.*
- *Promote the development of Islamic Capital Markets.*
- *Encourage the development of Islamic instruments.*

According to the Malaysia Islamic Finance Centre, the following table provides a breakdown of the Shari'ah compliant entities listed on the MYX, by industry vertical, as at May 2015.

	Shari'ah Compliant	Total Listed	Percent Compliant
Consumer	104	129	81%
Industrial Products	196	250	78%
Construction	36	43	84%
Mining	0	1	0%
Trading Services	153	210	73%
Properties	68	89	76%
Plantations	37	42	88%
Technology	72	90	80%
Infrastructure	4	6	67%
Finance	2	36	6%
SPAC	2	3	67%
Hotels	0	4	0%
Closed-End Funds	0	1	0%
Total	674	903	75%

Introduction to the TMX Group Inc.

The TMX Group Inc. with its ready access to the deep capital markets in both Canada and the U.S. provides the essential financing, equity capital and liquidity necessary for companies to grow and thrive. Through the facilities of its two equity markets, the TSX Venture Exchange (TSXV) and the Toronto Stock Exchange (TSX), the junior and senior equity exchanges respectively, the TMX provides access to financing for greater than 3300 companies broadly engaged in a diverse range of economic enterprises. As shown in the listings table below[xviii], the TMX list reflects both the diversity of Canadian economy as well as the particular areas of focus of the Exchange. These are: Mining, Oil & Gas, Financial Services, Manufacturing and technology.

Issuer Category		Issuers Listed
Mining		**1318**
Diversified Industries		**626**
Communications and Media	42	
Consumer & Industrial Products	311	
Financial Services	127	
Forest Products and Paper	19	
Real Estate	102	
Utilities & Pipelines	25	
Technology & Innovation		**419**
Clean Technology	112	
Life Sciences	124	
Technology	183	
Exchange Traded Funds (ETF's)		**374**
Oil and Gas		**358**
Closed End Funds		**210**
Capital Pool Companies (CPC's)		**41**
Special Purpose Acquisition Corporations – SPAC's		**5**
Total		**3351**

The Exchange prides itself in facilitating access to financing for all sectors and companies independent of their stage of growth.

Listing on the Toronto Stock Exchange

Gaining a Listing in Toronto will require the approval of the appropriate provincial securities commission as well as the Exchange. The first step in going public is to choose the appropriate market.

The TSX is a market for proven companies seeking superior capital raising, enhanced liquidity, specialized indices, broad analyst coverage and global visibility. The TSXV is designed for earlier staged companies where the listing requirements reflect the stage of development financial history and market prospects. The listing requirements for each reflect those profiles.

The second step is to select the method for going public. The options are: to complete an Initial Public Offering (IPO), or a Reverse Takeover (RTO), by entering into a Qualifying Transaction/Acquisition (for CPC's or SPAC's), or if already listed elsewhere via interlisting. Of course the method chosen will impact the listing requirements and process.

When considering a listing the TMX needs to strike a balance between the companies need for capital and providing safety and transparency for investors. It's very important that investors know the types of companies they're investing in, and the inherent risk in those companies. Fortunately the more successful that listed companies are; the more successful the Exchange itself is so there is a real incentive to find entities, regardless of stage or sector that will benefit and grow from being public.

In order to facilitate listings across the broad number of sectors and enterprises outlined in the table above and to reflect the different profiles and stages of growth, the TMX has developed detailed original listing requirements designed to admit companies that have the potential to grow, complete financings and be successful. This paper will not outline the minimum listing requirements for all of the sectors and sizes of companies but will initially highlight the TSX Industrial original listing requirements and then outline the Exchanges specific approach to Mining companies.

The table below summarizes the TSX listing requirements for three types of industrial companies: a non-exempt technology company; a non-exempt R&D company and an exempt industrial company. Exempt status, frees the company from specific aspects of exchange oversight (i.e. prior approval of material transactions or those involving insiders), and is given only to established companies who meet the criteria at time of listing. As you can see, technology companies (i.e. hardware, software, telecommunications, data communications, information technology, etc.) and R&D (i.e. biotechnology) companies are able to list without any earnings, revenue, cash flow or net tangible assets. This might be surprising given that this is possible for qualifying a senior board company but the TMX has set out clear criteria for this to be possible. In order to qualify, these companies will be required to establish, via substantiated and verified cash flow projections, that they have adequate working capital to finance their development plans including any cash raised coincident with listing. Technology companies will need to confirm that their products or services are at an advanced stage and that management is demonstrably capable of commercializing. R&D companies must have two prior years of successful operating history and provide evidence of the technical expertise and resources to advance its programs. The detailed listing requirements are provided in the table below.[xix]

Listing Requirements for Industrial, Technology and R&D Companies			
Minimum Listing Requirements	**Non-exempt Technology Issuers**	**Non-exempt Research and Development Issuers**	**Exempt Industrial Company**
Earnings or Revenue			Pre-tax earnings from on-going operations of at least $300,000 in the last fiscal year.
Cash Flow			Pre-tax cash flow of $700,000 in the last fiscal year, and an average of $500,000 for the past two fiscal years.
Net Tangible Assets			$7,500,000
Adequate Working Capital and Capital Structure	Funds to cover all planned development expenditures, capital expenditures, and G&A5 expenses for one year.	Funds to cover all planned R&D expenditures, capital expenditures and G&A expenses for two years.	Working capital to carry on the business, and an appropriate capital structure.
Cash	Minimum $10 million in the treasury, with majority raised by prospectus offering	Minimum $12 million in the treasury, with majority raised by prospectus offering	
Products and Services	Evidence that products or services at an advanced stage of development. OR commercialization and that management has the expertise and resources to develop the business.	Minimum two year operating history that includes R&D activities. Evidence of technical expertise and resources to advance its research and development programs.	
Management and Board of Directors	Management, including the board of directors, should have adequate experience and technical expertise relevant to the company's business and industry. as well as adequate public company experience. Companies are required to have at least two independent directors.	Management, including the board of directors, should have adequate experience and technical expertise relevant to the company's business and industry. as well as adequate public company experience. Companies are required to have at least two independent directors.	Management, including the board of directors, should have adequate experience and technical expertise relevant to the company's business and industry. as well as adequate public company experience. Companies are required to have at least two independent directors.
Public Distribution and Market Capitalization	1,000,000 free trading public shares. $10,000,000 held by public shareholders. 300 public shareholders each holding a board lot. Minimum $50 million market capitalization.	1,000,000 free trading public shares. $4,000,000 held by public shareholders. 300 public shareholders each holding a board lot.	1,000,000 free trading public shares. $4,000,000 held by public shareholders. 300 public shareholders each holding a board lot.
Sponsorship	Required	Required	Not Required

The TSXV has similar categories for smaller industrial, technology, life science, and real estate companies. They also maintain a Tier 1 and Tier 2 market so that even much smaller entities can access capital, generate liquidity and grow through public market financings. Typically most of these companies would not qualify for any type of debt financing.

Now let's take closer look at the Exchanges approach to listing Mining companies as described in the chart below.

Listing Requirements for Exploration and Mining Companies					
	TSX	TSX	TSX	TSXV	TSXV
Minimum Listing Requirements	**Non-exempt Exploration and Development Stage**	**Non-exempt Producer**	**Exempt Mining Producer**	**Tier 1**	**Tier 2**
Property Requirements	Advanced Exploration Property with a minimum 50% ownership in the property	Three years proven and probable reserves as estimated by an independent qualified person (if not in production, a production decision made).	Three years proven and probable reserves as estimated by an independent qualified person	Material Interest in a Tire 1 property.	Significant interest in a qualifying property or, at discretion of the Exchange, a right to earn a significant interest in a qualifying property; sufficient evidence of no less than $100,000 of exploration expenditures on the qualifying property in the past three years.
Recommended Work Program	$750,000 on advanced exploration property as recommended in independent technical report.	Bring the mine into production.	Commercial mining operations.	$500,000 on the Tier 1 property as recommended by geological report.	$200,000 on the qualifying property as recommended by geological report.
Working Capital and Financial Resources	Minimum $2.0 million working capital, but sufficient to complete recommended programs, plus 18 months G&A , anticipated property payments and capital expenditures. Appropriate capital structure.	Adequate funds to bring the property into commercial production; plus adequate working capital for all budgeted capital expenditures and to carry on the business. Appropriate capital structure.	Adequate working capital to carry on the business. Appropriate capital structure.	Adequate working capital and financial resources to carry out stated work program or execute business plan for 18 months following listing; $200,000 in unallocated funds.	Adequate working capital and financial resources to carry out stated work program or execute business plan for 12 months following listing; $100,000 in unallocated funds.
Net Tangible Assets, Earnings or Revenue	$3,000,000 net tangible assets.	$4,000,000 net tangible assets; evidence indicating a reasonable likelihood of future profitability supported by a feasibility study or historical production and financial performance.	$7,500,000 net tangible assets; pre-tax profitability from ongoing operations in last fiscal year; pre-tax cash flow of $700,000 in last fiscal year and average of $500,000 for past two fiscal years.	$2,000,000 net tangible assets.	No requirement
Other Requirements	Up-to-date, comprehensive technical report6 prepared by independent qualified person and 18 month projection (by quarter) of sources and uses of funds, signed by CFO.	Up-to-date, comprehensive technical report6 prepared by independent qualified person and 18 month projection (by quarter) of sources and uses of funds, signed by CFO.	Up-to-date, comprehensive technical report6 prepared by independent qualified person.	Geological report recommending completion of work program.	Geological report recommending completion of work program.
Management and Board of Directors	Management, including board of directors, should have adequate experience and technical expertise relevant to the company's business and industry as well as adequate public company experience. Companies are required to have at least two independent directors.	Same	Same	Same	Same
Distribution, Market Capitalization and Public Float	$4,000,000 publicly held 1,000,000 free trading public shares; 300 public holders with board lots.	$4,000,000 publicly held 1,000,000 free trading public shares; 300 public holders with board lots.	$4,000,000 publicly held 1,000,000 free trading public shares; 300 public holders with board lots.	Public float of 1,000,000 shares; 250 public shareholders each holding a board lot and having no resale restrictions on their shares; 20% of issued and outstanding shares in the hands of public shareholders.	Public float of 500,000 shares; 200 public shareholders each holding a board lot and having no resale restrictions on their shares; 20% of issued and outstanding shares in the hands of public shareholders.
Sponsorship	Required	Required	Not Required	May be Required	May be Required

The message from the above chart is the clear focus that the TMX applies towards the mining industry. Whether you are a large mining producer (i.e. a company that operates a mine and generates revenue from production and sale of ore) or an explorer at one of the various stages of the exploration and development, there is an opportunity to raise capital and go public. The listing requirements set out the Property requirements, including minimum proven and probable reserves for producers or the approved work program and ownership prerequisites for explorers. An advanced property is one that has an indicated three dimensional zone of mineralization showing a reasonable indication of continuity and where the resource is of a sufficient economic grade. Under the ownership rules the company must have the right to earn or maintain a minimum 50% interest in the property. In all cases, a property of geological merit must be deemed to be so by a "qualified person" (i.e. geologist, mining engineer, etc.) as asserted in specialized NI 43-101 report which outlines the recommended program of development.

The NI 43-101 Report must meet the legal requirements of the securities commissions in Canada as set out in National Instrument 43-101, hence where the report gets its name. Listing also requires companies to meet the working capital and financial resource prerequisites including the minimum cash necessary to complete the recommended work program, funding for general and administrative expenses and a surplus contingency.

Impact of the TMX Focus on Mining Sector

In 2015 the TMX was home to almost half of the total mining financings globally. Greater than 50% of the public mining companies around the world are listed on Toronto.[xx] They are diversified by both commodity type and stage of development. The majority of the exploration projects undertaken by these companies are being done outside of Canada.

Clearly the TMX dominates mining to a degree beyond that which could ever exist given Canada's size without the special focus given to Mining by the Exchange. This focus has resulted in the development of large capital pools to access and fund projects. To support these financings, a deep pool of talent – mining engineers, geologists, lawyers, accountants, financial analysts, commodity experts and experienced Exchange staff – all with a deep expertise in facilitating public mining financing has emerged. The large quantity of successful financings has led to global visibility, greater analyst coverage and specialized indices resulting in increased liquidity and trading which again has led to more listings and financings. This is indeed a virtuous cycle.

MYX and TMX Listing Comparison

A comparison of the initial listing requirements of the two exchanges certainly shows some similarities. There are requirements for eligibility that are similar including profit tests, cash flow, assets, governance, public distribution, sponsorship, post-IPO lockups (i.e. Escrowed Shares) etc. These are as you would expect and represent the kinds of standards that investors require of public companies.

What is striking though is the significant effort that the TMX has made to list and finance specific types of companies (Mining, Oil & Gas, Biotechnology, Technology, etc.). These are all sectors that exhibit the possibility of significant growth. The TMX has made a real and concerted effort to understand the path of development for these companies, the access to capital requirements, the risks at different stages and approaches to mitigation (i.e. 43-101 Reports and Expert Opinions) so as to facilitate getting these companies listed and capitalized so they can advance and grow. At every stage of development there is a market, including a private market that facilitates financial intermediation taking into account the specific characteristics of the companies needs regardless of the size, or sector or path to successful commercialization.

It is that kind of approach that was anticipated for the MYX as it relates fostering the equity market growth for Shari'ah compliant issues and it appears that very little if any of that opportunity has been considered or implemented in any kind of a detailed way. Certainly there are multiple opportunities for Bursa Malaysia, the SC and Malaysia itself to capitalize on its existing dominance in Islamic capital markets and its regional influence throughout South East Asia. It's encouraging that preferential tax treatments have already been devised since it identifies that there is a willingness to structure policy in order to nurture the growth of the Islamic equity marketplace Here are a some specific actions and thrusts that Malaysia, the SC and the MYX could be consider to move Islamic equity markets forward:

- Review the characteristics of development and capital requirements for consumer, industrial products, trading services, properties and technology which all already show a high degree of Shari'ah compliance. There will be an opportunity to access and finance similar companies in a prudent and safe manner at an earlier stage. If done successfully, Shari'ah compliant companies from around the world will seek out the Malaysian market. With those companies large capital pools – both domestic and foreign will follow.
- Consider an approach to micro-finance. There is much being done through crowd-funding that has the opportunity to finance very early stage companies before they access debt and become non-compliant. Interestingly enough most crowd-funding appears to embrace a *Mudarabah* type of contract.
- Consider approaches to amassing large equity capital pools to assist in providing equity funding for infrastructure investments. This could be done via the development of *Zakat*-based public pension funds. The benefit of this approach would be to both provide a higher proportion of equity funding for infrastructure projects while at the same time providing retirement pensions those meeting a needs test and all while making the necessary infrastructure improvements that society demands. These could range from solar or wind power to telephone networks and pipeline infrastructure.
- Consider an expansion of the REIT's and the trust sector. The MYX already lists REIT's and the majority of these will be listed under the Properties sector which has shown a high degree of

Shari'ah compliance. Consideration should be given to the development of an income trust model, which would embrace other sectors (retail, utilities, manufacturing, etc.). A similar sector existed in Canada until negative tax changes closed it down. Until that point it was the fastest growing segment of the TMX list. Most of this income trust products employed a model similar to a Murabahah or Ijarah Sukuk.

While the ideas introduced above are meant to provoke thought, it's not necessarily these ideas specifically that are specifically recommended to be implemented. The key message is that real research is required to understand establish the critical policies, methods and approaches that will facilitate the growth of the Shari'ah compliant equity-based financial markets. While much of the focus of Islamic finance to date has been on Shari'ah compliant product innovation – it's time to switch gears and focus on fostering equity-based growth in Islamic capital markets.

Comparison of Islamic Indices

As indicated above, approximately 75% of the equities listed on the MYX are Shari'ah compliant. The Bursa has created a Shari'ah Advisory Committee (the "SAC") to make determinations of the Shari'ah compliance of any listed issuer. There is two stage screening process for confirming Shari'ah compliance. The first, Shari'ah stock screening is comprised of sector screening which excludes entities that violate the prohibited activities listed further above. It is recognized that most companies will not be 100% clean and so there are standards for assessing "mixed companies. For example there can be no more than 5% a company's revenue derived from the sale of pork or conventional finance activities. The second stage is financial screening which is focused on the capital structure of the entity. For example interest-based debt cannot exceed the trailing 24 month average of the market capitalization of the company by greater than 33%.

It is from that subset of Shari'ah compliant listings that the Bursa Malaysia has created two major Shari'ah compliant indices. These are the FTSE Bursa Malaysia EMAS Shari'ah Index (FBM EMAS Shari'ah) and FTSE Bursa Malaysia *Hijrah* Shari'ah Index (FBM *Hijrah* Shari'ah). The *Hijrah* index reflects a further more strict screening criteria and the index is made up the largest 30 companies who meet that stricter criteria. An example of the further restriction is the preclusion of companies involved in arms manufacturing. These indices are critical for the creation of ETF's and other index-linked product as well as measuring the performance of funds and to provide a benchmark for the entire market. Becoming part of the index is based on a determination of capitalization, liquidity and the size of the float.

The TMX has also created a Shari'ah compliant index which is the S&P TSX 60 Shari'ah. Similar to the MYX, a series of sector based screens and accounting screens is used to determine eligibility and continued Shari'ah compliance. Rather than employing an in-house SAC like the MYX, S&P has employed a third party to conduct the screening. That third party maintains a Shari'ah Supervisory Board that interprets business issues and recommended actions related to the inclusion in the index. Inclusion in the TSX 60 Shari'ah index primary reflects market capitalization.

Comparison of Shari'ah Indices

In comparing the MYX and the TMX in regard to the Shari'ah compliant indices it's clear that they follow a similar approach to screening and inclusion. The MYX does provide more choice in that it has a secondary, more strictly compliant index that will appeal to some more devout investors.

The aspect that is more striking though is again the lack of development in the Malaysian market. The TMX has almost 200 indices that reflect different sectors, currency denomination, large cap vs. small cap, commodity specific, growth vs. dividends, etc. This market depth and diversity is exactly what's need for the Bursa Malaysia in order to grow Shari'ah compliant equity-based financing in the market place. There has not been a significant degree of innovation or diversification or the index product creation that is necessary for driving greater equity demand and to attract both domestic and global investors interested in Shari'ah compliant investing. This should be pursued openly and with some immediacy.

Conclusion

This paper examined growth in Islamic financial and capital markets over the last 40 plus years since inception. The Islamic has expanded beyond banking to insurance (*Takaful*) and into capital markets (debt, equity and derivatives). Islamic financial markets demand Shari'ah compliance and much of that compliance has come from real product innovation. Islamic debt, called Sukuk has been far and away the key performer in terms of market leadership and growth. While described as an Islamic debt there are key elements of Sukuk that differ from conventional fixed income investments and that determine Shari'ah compliance. Still there is controversy Sukuk design and compliance. There is also a general feeling that in order to meet the full objectives of a Shari'ah way of life that Islamic finance needs to embrace full rather technical compliance. The 2008 global financial crisis has indicated the need to move away from debt-based economies. This has created an opportunity for Islamic finance to promote a more equity-based system consistent with Islamic ideals. In order to explore the potential, a comparative analysis was made of the initial listing requirements of the TMX versus the Bursa Malaysia (MYX). The intent was to understand the potential for expanding and growing Islamic equity-based financings. A further comparison was made of the approach of the two exchanges related to their Shari'ah indices. The research and comparative analysis has determined that there is indeed much more that can be done to expand the depth and diversification of Islamic capital markets and indices. There is a fundamental need to move away from product innovation and towards completing the critical research and innovation that will lead to sustainable Islamic equity markets growth. This is the key to Islamic markets moving forward.

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“CONVERGENCE BETWEEN ISLAMIC VENTURE CAPITAL AND CONVENTIONAL VENTURE CAPITAL” – NOTES
Conventional Venture Capital: “The Structure and governance of venture-capital organizations” William A. Sahlman

Akhbar Mohammed

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“In each of the last several years, venture-capitalist disbursed approximately $3 billion to fewer than 2,000 companies, most in high-technology industries. Although a typical large venture-capital firm receives up to 1,000 proposals each year, it invest in only a dozen or so new companies.” 475

- “By venture capital I mean a professionally managed pool of capital that is invested in equity-linked securities of private ventures at various stages in their development. Venture capitalists are actively involved in the management of the ventures they fund, typically becoming members of the board of directors and retaining important economics rights in addition to their ownership rights.” 473
- The contracts share certain characteristics, notably:
    - Staging the commitment of capital and preserving the option to abandon,
    - Using compensation systems directly linked to value creation,
    - Preserving ways to force management to distribute investment proceeds
- These elements of the contracts address three fundamental problems:
    - The sorting problem: how to select the best venture capital organizations and the best entrepreneurial ventures,
    - The agency problem: how to minimize the present value of agency costs,
    - The operating-cost problem: how to minimize the present value of operating costs, including taxes. - 474

“Optimal Investment, Monitoring, and Staging of Venture Capital’ The Journal of Finance, Vol. 50, No. 5 (Dec., 1995), 1461-1489.

Thesis: This paper examines factors affecting the structure of periodic investment by venture capitalist. The evidence indicates that the staging of capital infusions allows venture capitalist to gather information and monitor the progress of firms, maintain the option to periodically abandon projects.

“Venture capital funds’ high-powered compensation schemes examined by Gompers and Lerner (1995) give venture capitalists incentives to monitor firms more closely because their individual compensation is closely linked to the funds’ returns.” 1467

“Venture capitalists are concerned that entrepreneurs with private information and large private benefits will not want to liquidate a project even if they have information that the project has a negative net present value for shareholders. Entrepreneurs may also pursue strategies that enrich their reputation at shareholders’ expense. Agency costs increase with declining asset tangibility, increasing growth options, and greater asset specificity. Venture capitalists monitor entrepreneurs with increasing frequency as expected agency costs rice.” 1485-1486

“The evidence indicates that venture capitalist use their industry knowledge and monitoring skills to finance projects with significant uncertainty. Venture capitalists concentrate investment in early-stage companies and high technology industries.” – 1487

Sami Al-Suwailem “Venture Capital: A Potential Model of Musharakah” Islamic Econ, Vol. 10, pp 3-20 (1998)

- “A venture capital firm manages funds provided by investors an directs it to the most promising ventures, mainly in the form of equity. The venture capitalist, who is responsible for managing investors’ funds, provides financial and strategic assistance to the recipient company and actively participates in its management. The support continues until the venture materializes, at which stage an outside investor might be interested in owning the company, or it might be able to go public. Returns then are distributed back to the investors.” – 3

Definition:

- General partners are responsible for managing the funds and directing them to the most promising ventures. They are typically experienced in particular industries. Usually, they contribute a small percentage (1%) of committed capital. Their compensation is based on the total committed capital as well as on realized gains on the fund.
- Once a venture capital fund has been established, the venture capitalist must identify investment opportunities, arrange deals with entrepreneurs, monitor the investments, and ultimately achieve some return on his capital. The venture capitalist usually invests in recipient companies in the form of convertible preferred stock; that is, preferred stock that can be converted into common stock. Venture capitalist takes an active role in the recipient companies through membership on boards of directors. 4

- The Venture capitalist continues his financial, managerial and marketing support until the venture materializes. At this stage, an outside investor might be interested in owning the recipient company, or the recipient company might prepare to go public. 4

Sharing:

- Venture capital is structured around a basic theme – sharing. Investors are limited partners, the venture capitalist is a general partner, and the venture capital fund finances entrepreneurs through equity. All parties, therefore, have in essence the same objective. This structure dramatically reduces possible conflicts of interest and associated moral hazard. - 5
- Debt contracts, in contrast, suffer form inherent conflicts of interest between the borrower and the lender. Since the entrepreneur has to pay fixed payment regardless of the performance of the project, he will be better off choosing risky actions, exposing the lender to the risk of default. This leads to serious moral hazard problems and agency costs. – 5

Staging Capital Commitment:

- By staging capital, such incentive is inhibited, since the entrepreneur has to return to the venture capitalist to obtain capital for the next stage of the project. This mechanism, furthermore, encourages the entrepreneur to optimize his efforts to convince the venture capitalist to continue his support. – 7
- Staging the commitment of capital also helps reduce the uncertainty typically surrounding small ventures. As time passes, the venture capitalist is able to gather more information about the team, the market and the products, thus reducing major risk and uncertainties considerably. - 7

Benefits of Venture Capital:

- Factors that help reduce adverse selection can be classified into two categories. One category includes factors that create incentives for high-quality entrepreneurs to remain in the market in spite of the costs involved. The other includes those that create incentives for venture capitalist to back entrepreneurs of unknown quality or believed to be of the low quality type. – 8
- Traditional sources of capital, e.g. banks, are usually reluctant to provide capital to such ventures because of the high risk involved. – 8
- Many high quality entrepreneurs, although innovative and productive, lack the required experience in management, marketing, and financial planning. In this case the entrepreneur might be willing to accept venture capital in compensation for the experience and contacts for the venture capitalist. – 8

Growth and development:

- The structure of venture capital is well suited to addressing problems of informational asymmetry and agency cost that are most pronounced in high-risk environments with high potential of growth, such as high-tech industries and small businesses, as well as emerging markets and developmental projects. - 10
- Sagari, a researcher at the International Financial Corporation (IFC) criticizes World Bank operations which attempt to provide financial support for development mostly through long-term loans. This model of financial development "has provided in practice a fertile ground for the flourishing of moral hazard problems which jointly with inadequate follow-up have led to a poor performance from both a developmental and financial perspective". - 11
- Sagari then suggests the model of venture capital to those in practice attempt to solve some of the financial problems of the developing world. – 11
- Bond and Carter (1994) point out that commercial banks are not suited to financing infrastructure projects in developing countries. Banks cannot lend large volumes of long-term debt simply because they are constrained by the time profile of their deposits. 11
- Other institutions with long-term deposits, e.g. pensions funds and life assurance companies, provide a much better match of maturity but are highly risk-averse.
- A successful venture capital market requires well defined property rights, an affective legal system, positive social attitudes towards sharing, as well as entrepreneurial activities, and an efficient mechanism for venture capitalists to cash out their investments, such as functioning market for public securities and/or mergers and acquisitions. – 11

Financial Instability:

- Although Minsky provides a compelling theory of aggregate economic performance, he apparently provides no remedy for financial instability. Capitalism is inherently unstable. Minskians advocate discretionary economic policy as a way of mitigating the influence of financial shocks, but realize that the "lender of last resort" policy only deepens the long-term trend towards fragility. -11
- Equity enjoys "superiority to debt in terms of risk-sharing" and therefore, "a greater proportion of equity in a balance sheet reduces risks of financial fragility, bank runs, and systemic risk".

Use for Introduction:

Performance of Venture Capital Funds:

- In 1978 congress approved the 1978 Revenue Act, which reduced the personal capital gains tax form 49.5% to 28%. Many believe that this reduction played a major role in stimulating equity investments in venture capital funds.

Size of the Venture Capital Market:

- **Get data**

Performance of Venture Backed- Companies:

- In general, there is enough evidence to believe that venture-backed companies perform superiorly compared to similar non-venture backed ones. This is consistent with the premise that venture capital addresses agency problems than traditional finance. – 15
- Venture backed firms have a higher variance of earnings per share than non-venture backed firms. Venture backed firms use lower levels of debt than non-venture backed firms. Venture backed firms have higher R&D spending levels that non-venture backed firms. Venture-backed firms achieve higher growth rates in revenues and total assets than their counterparts. – 15

Samuel Kortum and Josh Lerner, "Assessing the Contribution of Venture Capital to Innovation" Rand Journal of Economics – February 2000

- Venture capital – defined as equity or equity linked investments in young, privately held companies, where the investor is a financial intermediary who is typically active as a director, an advisor, or even a manager of the firm – dates backed to the formation of American Research and Development in 1946. – 676
- This estimate suggests that venture capital accounted for 8% of industrial innovation in the decade ending in 1992. Given the rapid increase in venture funding since 1992, and assuming that the potency of venture funding has remained constant, the result imply that by 1998, venture funding accounted for about 14% of U.S. innovative activity. - 691

"Fundamental Requirements for Building an Islamic Venture Capital Model" Elsayed Elsiefy – Vol. 3, No.1; 2014

Stages of Venture Capital Funding:

- Equity is the simplest form of finance where the investor buys part of the company or the project for an agreed price and become partner by percentage according to his capital contribution.
- For more security then equity investors sometimes prefer to join the company first by convertible debt then if the business nourishes, they transfer debt into equity. The VC investor provides financing to the enterprise as a loan at an agreed interest rate, but the loan becomes convertible into equity in the enterprise.
- VC investors typically require as a precondition to their investment that they receive certain protections and rights that are superior to those of the founders or early angel investors. In most jurisdictions the investment goals is achieved by the VC purchasing preferred shares which rank above the existing common shares. - 59
- Warrants are a type of security that entitles the holder to buy a proportionate amount of common stock or preferred stock at a specified (typically nominal) price for a period of years subsequent to investment. In the VC context, warrants are effectively a form of bonus for the VC investor in the event that the enterprise performs well. – 59
- VC investors often insist on obtaining a minimum return on their capital before other shareholders receive any return. This amount may equal to the VC investor's investment (or multiple thereof) and may be triggered by a variety of exit events, or it may only be triggered in a liquidation scenario. Once the investor receives the agreed return, the surplus is distributed generally, pro rata

amongst shareholders. Liquidation preference is not a sharia compliant concept, although equivalent provisions or stand-alone agreements can be structured to give effect to his principle. – 60

- VC investors will want to ensure that the founders and management enter into appropriate non-compete arrangements, especially as in most VC scenarios the value of the company lies with the management and the founders. A VC venture will often want to work to ensure that it is not incurring the expense in third party advisory fees and time and effort in due diligence and other work if the company is also negotiating with other parties. - 60

Islamic Venture Capital:

“Fundamental Requirements for Building an Islamic Venture Capital Model” Elsayed Elsiefy – Vol. 3, No.1; 2014

1. Shariah advisory: whose function is to provide continuous guidance in ensuring compliance with shariah investment principles.
2. All activities of the company should be Shariah compliant including the methods of financing. There is a difference between investing in VC as major shareholders and investing in stock. When investing in stocks, there is AAOIFI resolution which allows investing in companies that have permissible core business but that interest financing, not more than 30% of the capital of the company and also can have some percentage 5% of unlawful business.
3. Financial instruments provided in venture capital should be fully compliant with major views of Islamic financial instruments.
4. The development of robust legal structures is complied with international standards. We need a set of laws that respect intellectual property rights and patents. This is particularly crucial because in order to practice venture capital and encourage people to invest, we need to first provide the legal ground so they can feel safe undertaking a risky investment.
5. Standardize musharakah contact: The Musharakah contract as it exists now has many technical and ethical problems that make it very difficult to raise financing through it. It is essential to transform Musharakah into truly dynamic nature of shareholding, one that could provide both active participation at the level of decision making and entrepreneurial contribution remains absent, once the powers of decision making are vested with those in authority. VC need support specially in the pre seed and seed stage, we recommend that we use Musharakah in all early stages of VC and do not use Mudarabah until the company is developed. – 61
6.

Shar’iah:

Mufti Muhammad Taqi Usmani – “The Concept of Musharakah and its application as an Islamic method of financing” 14 Arab L.Q. 203 – (1999)
Contractual Structure:

Musharakah:
means joint enterprise in which all the partners share the profit or loss of the joint venture.

Interest predetermines a fixed rate of return on loan advanced by the financier irrespective of the profit earned or loss suffered by the debtor, while musharakah does not envisage a fixed rate of return. Rather, the return in musharakah is based on the actual profit earned by the joint venture. - 203

According to Islamic principles, a financier must determine whether he is advancing a loan to assist the debtor on humanitarian grounds or if it is to share profits in the business. If he wants to assist the debtor, he should resist claiming any excess on the principal on his loan, because his aim is to assist. However, if he wants to have a share in the profits of his debtor, it is necessary that he should also share with him in his losses. Thus the returns of the financier in musharakah have been tied up with the actual profits accrued through the enterprise. – 204

"A new form or procedure in musharakah cannot be rejected merely because it has no precedent in the past. In fact, every new form can be acceptable to the Shariah in so far as it does not violate any basic principle laid down by the Holy Quran, the Sunnah, or the consensus of the Muslim jurists. Therefore, it is not necessary that musharakah be implemented only in its traditional old form" – 204

Musharakah is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary characteristics of a valid contract must be present here also. - 206

Distribution of profit:

- The proportion of profit to be distributed between the partners must be agreed upon at the time of effecting the contract. It no such proportion has been determined, the contracts of musharakah is not valid. – 206
- If an amount in a lump sum or a certain percentage of the investment has been agreed for any one of the partners, it must be expressly mentioned in the agreement that it will be subject to the final settlement at the end of the term, thereby meaning that any amount so drawn by any partner shall be treated as an "on account payment" and will be adjusted to the actual profit he may deserve at the end of the term – 206/207

Mudarabah:

Mudarabah is a special kind of partnership where one partner gives money to another for investing in a commercial enterprise. The investment comes from a partner who is called rab-ul-mal, while the management and work is the exclusive responsibility of the other who is called the mudarib. – 212

- Investment is the sole responsibility of the rab-ul-mal

- The loss if any, is suffered by the rab-ul-mal, only because the mudarib does not invest anything. His loss is restricted to the fact that his labour has been in vain and his work has not brought success for him.
- All the good purchased by the mudarib are solely owned by the rab-ul-mal, and the mudarib is entitled to his share in the profit only in the case where he sells the good profitably. Therefore, he is not entitled to cliam his share in the assets in themselves, even if their value has increased. – 212/213

Combination of musharakah and mudarabah:

1. A contract of mudarabah normally presumes that the mudarib has not invested anything to the mudarabah. He is responsible for the management only, while all the investment comes from the rab-ul-mal.
2. This type of partnership will be treated as a combination of musharakah and mudarabah. Here the mudarib may allocate for himself a certain percentage of profit on account on his investment as sharik, and at the same time he may allocate another percentage for his management and work as a mudarib.

1. Financing through musharakah and mudarabah never means to advance money. It means to participate in the business and share the assets of the business to the extent of the ratio of financing.
2. An investor/financier must share the loss incurred by the business to the extent of his financing.
3. The partners are at liberty to determine, with mutual consent, the ratio of profit allocated for each one of them which may differ from the ratio of investment. However, the partner who has expressly excluded himself from the responsibility of work for the business cannot claim more than the ratio of his investment.
4. The loss suffered by each partner must be exactly in the proportion of his investment.

Sami Al-Suwailem “Venture Capital: A Potential Model of Musharakah” Islamic Econ, Vol. 10, pp 3-20 (1998)

- “A venture capital firm manages funds provided by investors an directs it to the most promising ventures, mainly in the form of equity. The venture capitalist, who is responsible for managing investors’ funds, provides financial and strategic assistance to the recipient company and actively participates in its management. The support continues until the venture materializes, at which stage an outside investor might be interested in owning the company, or it might be able to go public. Returns then are distributed back to the investors.” – 3

Masadul Alam Choudhury “Islamic Venture Capital: A Critical Examination” journal of Economic Studies 28, 1 pp. 14-33.

“Problems have arisen because of the restrictive and dichotomous ways in which these two instruments are used, causing the non-participatory nature of sharing profits through them, as agents remain in sleeping partnership between being owners of capital who are not entrepreneurs, and workers who provide effort in producing profits.” 14-15

“The inherent problem in the existing m&m joint venture financing instruments results in their lack of precision in capitalizing the value of time or wages that workers and similar participants contribute in a joint venture, along with financial capital contributions from owners of capital” - 15

“The m&m is simply a financial contract between owners or between workers regarding the sharing of profits ex-post according to predetermined sharing ratios.

Mudarabah

First, the profit-sharing ratio remains an agreed upon ratio but not a precise basis for capitalizing the value of work effort. This ignores the distributive issues of entitlement, empowerment, participation and re-contracting among participants. Second, owners of capital pass on the productive enterprise to labour, such as an Islamic bank. In either of these two cases, there comes about a sleeping partnership between the owners of capital and labour. Such a sleeping partnership devolves into a dominant decision-making power for owners of capital at the expense of empowerment and continuously changing ownership by workers in the enterprise.” 17

Musharakah

“in the case of musharakah contact the partners are all capital owners who can pool their financial capital in a joint venture and thus share the profits and losses at the end of the contract period according to their initial shares of capital investments.” 18

“Musharakah venture capital management faces the same problem of asymmetrical ownership and income/wealth distribution as in the case of mudarabah. The fact of the matter is that only truly co-operative and well co-ordinated enterprise must be extensively participatory in nature. We should then expect labor relations from a mudarabah contact to interwine with musharakah contracts. Such an interrelationship between the instruments would re-create the same kinds of problems that we noticed in the case of mudarabah" - 18

Example of Industrial democracy:

"An important labour relation of this type now appears in the USA is industrial democracy, wherein capitalist and workers are required to collaborate in management and production. Good examples of industrial workplace democracy are employee savings and ownership plans (ESPOs) and universal savings and ownership plans (USOPs). (Ellerman, 1991). Workers can buy shares in enterprises with the hope of buying back failing companies. In this kind of a re-contracting situation ownership can increase even though wage-payment remains extant. The same kind of co-determination and re-negotiation is not available in mudarabah and musharakah enterprises as long as these contracts remain dichomtomous and de-linked from the productive factors and outlets." 19

"in the case of either the two instruments for raising and mobilizing Islamic venture capital we find that democratic decision making and participation are not explicitly built into the financial and distributive nature of the contracts. In the case of mudarabah, after a negotiated contract is initially established, subsequent management of the enterprise does not rest on the joint decision making powers of the two sets of partners. Rather, it devolves on the major controlling powers of ownership of capital or on the externally arranged management employed by the owners, such as an Islamic bank. Thereby, in case of financial loss the capital owner and not labour becomes liable to bear the loss. The resulting higher risk borne by the capital owner puts him or his appointed management at the helm of decision making." – 19

"The technical problems of m&m arise first, due to their restrictive terminological usage among Islamic economists, and second, because of their peculiar financial definitions that fail to realize co-operative partnership among capital owners and non-capital partners including labour." 21

"Consequently, the objectives of socio-economic development must promote entitlement, ownership and decision making by participation on the one hand, and on the other hand bring about financial risk diversification through re-negotiated contracts, are not found to emerge from these two financial instruments as they presently exists." 21

“The complete adoption of the basic methodology the principal agent-problem, now repeated for m&m, imitates the usual risk-aversion behavior solely premised on the assumption of economic rationality and equilibrium-optimal allocation of resources.” – 22

Critique of Mudarabah and Musharakah in reference to the classical Islamic period

Ismail (1989) makes a good study of this issue and finds that there exists no evidence as to whether the Prophet categorically approved of these modes of financing, although he did not ban them.” 22

“Since there does not exist any clear saying and practice of the Prophet with regard to mudarabah financing of venture capital, and all cases wherein the companions of the Prophet participated in such a business remain circumstantial rather then precise rules of business ethics, therefore, the pre-Islamic character of mudarabah bears little essence of the truly Islamic mode of conducting extensively co-operative and co-ordinated participatory business practice under shari’ah.” – 23

“Instead, in the Qu’ran and ahadith (Prophetic sayings) there appears the central role of economic co-operation and active participation for purposes of generating productive yields that bring about wellbeing to society. This is the goal of shariah (maqasid al sharia). – 23

“Instead, the accepted generalized instrument of Islamic financing, raising and mobilization of venture capital can be any mode of financing that promotes explicit rules of extensive participation among co-operative agents, businesses, sectors, variables and relations in the entire Islamic socio-economic order. Through such participatory rules and co-operative relationships can extensive web of socio-economic complimentarity among possibilities can be well established. The result is a realization of community social wellbeing, wherein the ethics of elimination of interest is endogenously realized, put into effect and then regenerated within the system” – 23

“The result would be a realization of both financial profitability in terms of the productivity of capital and its development in terms of increasing empowerment, entitlement and ownership among partners including labour.” – 23

A simple formalism on Islamic participatory venture capital:

1. First, it must yield prospective returns from resource mobilization into shari'ah approved possibilities. These would then be causally related with the productivity of capital and risk diversification.
2. Second, the ethical recommendations and productivity of financial resources in possibilities acceptable to shari'ah must generate development effects.
3. From the joint effects of these two expectations, Islamic participatory financing would generate extensively co-operative and coordinated interrelationships among agents, systems and variables.
4. A communitarian outlook of social well-being is thus established through the medium of Islamic participatory instrument in terms of pervasive
5. Empowerment, entitlement and ownership become developmental goals with the increasing possibility of re-contracting profit and loss sharing within capital-labour participatory relations. (Tahir, 1997)

TAKAFUL AS A FORM OF ETHICAL INSURANCE IN CANADA

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ABSTRACT

Islamic Insurance, known as Takaful, is experiencing rapid growth around the world. Canada plans to position Toronto as a North American hub for Islamic finance. From the perspective of the insurance sector, it is important to consider some of the challenges faced in other jurisdictions around the world. This paper aims to act as a market primer to explore Takaful issues in a holistic and global context for Canadian consideration. It does so with three objectives in mind 1) exploring the history of insurance to understand the context in which it emerged, 2) understanding challenges globally, by collating themes of issues that can be faced in Canada for Takaful, and 3) recommending solutions for these challenges. Research methodology utilized in achieving these objectives was a mixed approach of primary and secondary sources. Secondary data such as books, journal articles, scholarly publications, and conference presentations were researched. Additionally, expert opinions were collated through open ended interviews. In order to penetrate the Canadian market, various recommendations have been made in this paper, but a recommendation to rebrand Islamic insurance is perhaps one of the most important ones. Canadian's may respond better to Ethical Insurance rather than Takaful. As Islamic finance and Takaful enters the Western world, the regulatory structure will have to evolve to meet the needs of an 'east meets west' approach.

Keywords: Insurance, Ethical Insurance, Takaful, Mutual Insurance, Canada

INTRODUCTION

The insurance sector is a major contributor to the economy due to the sheer size of the premiums collected, the scale of its investments, and its role played in covering personal and business risks[xxi]. The U.S. insurance industry's net premiums totalled $1.1 trillion in 2014[xxii], and in Canada, similar net premiums totalled $49.5 billion[xxiii].

Yet despite its economic importance, the insurance sector has a mixed growth pattern, with mature markets stagnating and emerging markets contributing significantly to the global premium growth. In 2013, 84% of the premiums came from mature markets such as Canada, U.S and England, but they only contributed 45% to overall sector growth[xxiv].

While the global sector has seen a recent recovery compared to 2013's decline, studies warn that emerging technologies and growing emerging markets are putting pressure on insurance companies to innovate and remain competitive[xxv]. Recent developments in emerging markets include regulatory pushes for more stringent capital requirements, expansions of micro insurance covering low-income households and *bancassurance* as a distribution channel (partnerships between banks and insurance companies).

Interestingly, according to Swiss Re's 2008 *sigma* study, a faith based type of insurance known as Takaful, was the most widely used and accepted model utilized[xxvi] in addressing developments in emerging markets.

Today, the global market for Takaful (Islamic insurance) has experienced rapid growth. The industry has expanded in recent years, with a compound annual growth rate of 22% between 2007 and 2011[xxvii]. This has primarily been driven by an increasing Muslim population, growing oil wealth, and the attractiveness of Islamic banking services to the non-Muslim population[xxviii]. Markets such as Saudi Arabia, Malaysia, Indonesia, United Arab Emirates and Sri Lanka have all contributed to this accelerated growth rate. Additionally, modest growth has been experienced in developed markets such as the United Kingdom[xxix].

Given the large Muslim population in Canada (currently at 2.8% and anticipated to grow to 6.6% by 2030)[xxx], and Canada's commercial ties with the Middle East, Canada plans to position itself as a North American hub for Islamic finance[xxxi]. Canada's recent Islamic Finance Outlook Report proposes Toronto as becoming a global reference point for information, insights and analysis[xxxii]. Due to Canada's history and existence of mutual insurance (since 1839[xxxiii]), it is conceivable that the Canadian regulatory framework is also poised to adopt relatively small changes to accommodate Takaful insurance. While Canada contemplates the entrance of Takaful, it is worth reflecting on some of the challenges faced in other jurisdictions around the world, since many of these challenges could be experienced in Canada.

RESEARCH PROBLEM AND METHODOLOGY

Due to the relative nascency of the sector, there is limited research on the topic of Takaful. There is some literature exploring shortfalls and critiques. However, since the insurance sector is jurisdictionally regulated, topics covered tend to be market and region specific.

This paper aims to act as a market primer to explore Takaful issues in a holistic and global context for Canadian consideration. It does so with three objectives in mind:

- Understanding the history of insurance, by looking at the context in which it was developed;
- Understanding Takaful challenges around the world, by collating themes of issues; and
- Recommending Canadian considerations for the adoption of Takaful.

Research methodology utilized in achieving these objectives was a mixed approach of primary and secondary sources. In understanding the history of Takaful and its current challenges, secondary data such as books, journal articles, and scholarly publications were researched. This research helped create thematic challenges that were then posed to industry professionals as open ended interview questions. This provided expert opinion and insights to form considerations. Additionally, secondary sources such as conference presentations and consultancy publications were also used to form recommendations.

For the purpose of this paper, interviewees have been kept confidential. Interviewee 1 is a former CEO of a Takaful operator in the United Arab Emirates [I1][xxxiv]. Interviewee 2 is a prominent global Takaful executive with experience in Nigeria and Sri Lanka [I2][xxxv]. Interviewee 3 is a Senior Manager of a large reinsurance company that offers retakaful services globally [I3][xxxvi].

This paper is organized into three sections, matching the objectives identified above. Section 1 explores the historical context of insurance and demonstrates how the concept of insurance actually originates from the Arab world itself. Section 2 reports nine issues and challenges faced by the Takaful sector globally. Section 3 offers considerations and recommendations to the respective challenges identified in Section 2. The paper then closes with a conclusion and identification of some of the limitations of the research conducted.

SECTION 1 – AN HISTORIC CONTEXT FOR INSURANCE

1.1 - Understanding Present Day Insurance and Takaful

In the modern world, insurance can be described as "a contract between an insurance company and its customers for a specific period of time. It protects the customer financially against a loss. Insurance is also a mechanism for dispersing risk, because it shares the losses of the few among the many"[xxxvii]. In traditional insurance thus, insurers protect policyholders against risk. Shareholders invest in an insurance company and provide it with capital. Policyholders contribute revenue as customers. Using this capital, insurance companies comply with regulatory reserve requirements, and generate investment income through remaining capital[xxxviii]. After paying out claims and operating expenses, profit generated is distributed amongst shareholders. The goal of a conventional insurance company is profit maximization.

Takaful, commonly referred to as Islamic Insurance, is the counterpart to for-profit insurance. According to the Islamic Financial Services Board (2014), "Takaful is derived from an Arabic word that means joint guarantee, whereby a group of participants agree among themselves to support one another jointly for the losses arising from a specific risk"[xxxix]. The differences between the two concepts lie in the philosophy of the product, the method of risk management, investment principles and the treatment of surplus[xl].

Philosophy: Takaful operates a little like mutual insurance in Canada, in that in both cases, the philosophy surrounding the product is mutual help, and not profit maximization.

Risk Management: Unlike for-profit insurance, risk in Takaful is shared amongst policyholders (instead of transferring it to the insurance provider) and the insurance company itself acts as an operator. Policyholders pool their contributions and share the liability of each participant[xli].

Treatment of Surplus: In for-profit insurance, surpluses and profits are paid out to investors, as a return on their investment in the business. In Takaful however, the goal is not profit maximization, but rather is self-sustaining operations. Any profits earned or surpluses belong to policyholders. Depending on the type of Takaful model utilized, this could be rebated back to the policyholders at the end of the year, it could be shared with policyholders and the operator in a specific percentage[xlii], it could be returned to the policyholders after paying out operator fees, it could result in reduced future premiums, and so on[xliii]. Furthermore, in Takaful specifically, in the event of a deficiency, the operator provides an interest free loan to cover shortfalls[xliv], which is paid back by policyholders.

Investment Principles: In for-profit insurance, investment of funds is conducted in a manner as deemed appropriate by the board and the executives. In Takaful alternatively, investment must also be guided by Islamic Law (known as *Sharia* in Arabic). The investment of funds is governed to exclude investment in activities that contain speculation or uncertainty, gambling, and interest[xlv]. Investment in assets and securities is limited to those that do not generate revenues from prohibited products such as armaments, gambling, tobacco, alcohol, pork, nor are investments made to earn unlawful profits involving interest.

Thus, unlike conventional insurance, the governance of Takaful companies requires an additional supervisory board, commonly referred to as a Sharia Advisory Committee, to verify product offerings, investments and general operations in line with Sharia principles.

1.2 - Global History of Insurance

While the concept of Takaful may seem foreign to some, the earliest known basis of true insurance actually lie in the Arab world that emerged in the Nile Valley, Mesopotamia and the Levantine. Amongst their legislative endeavours to govern civilization, the Code of Ouramo introduced the principle of blood money and compensation. Later adopted by Babylonians, the Hammurabi Code of 2250 B.C. consisted of 282 articles of which 7 directly reference the concept of insurance. This included legislation such as builder's insurance, life dependent compensation, merchant insurance, and so on[xlvi].

As the maritime activities of the Babylonian empire expanded, the famous 'Bottomry Contract' was created. This early form of insurance arose out of a need for like-minded individuals, in like-minded business ventures, to cover and share risks. It was not intended for the creation of profit at the time. This bottomry contract thus introduced elements such as repayment of cargo loans being dependent upon arrival of the cargo, and interest rates for cargo loans being higher to reflect higher risk[xlvii]. This concept was adopted by the Phoenicians in the Mediterranean (the Greeks), which was then further fine-tuned and adopted by the Romans. In the written works of Greek Demosthenes (384-322 B.C), the description of bottomry contracts parallels what was later employed in early 20th century in London[xlviii]. In contrast to modern insurance contracts however, most of these were private contracts and often structured through shared ownership, much like the mutual insurance sector we know today.

Despite this longstanding history, the developed for-profit form of insurance only started in the 14th century and this formed the divergence from a shared insurance model to a profit based one. As trade routes expanded, so too did the demand and need to formalize insurance. Given the limitations of finding industry specific merchants to form mutual insurance groups, profit based models thus emerged as a viable option, with shareholders insuring various goods and products. To support growth, Barcelona became the first city to enact insurance legislation in the year 1435. By 1552, the first commercial marine insurance policy was printed on an official form in Spain. By 1558, Queen Elizabeth enacted the Law of Elizabeth to regulate marine insurance[xlix].

With the success of profit based insurance companies, operators began seeking new markets to enter into. For-profit insurance spread from Europe to the Middle East through Istanbul, being the capital of the Ottoman Empire. By the 19th century, the Nile Valley once again became an important region for insurance, with Cairo becoming the center of insurance for the Middle East. By this time, the old form of mutual insurance became a topic of history, and modern day for-profit insurance was now prevalent.

With profit maximization in mind, and investment in any form of business (including alcohol), the working Muslim found insurance to be contrary to Sharia law. However, a famous decree by a religious leader named Shaikh Mohamed Abdou in 1903 confirmed that the use of modern day insurance was permissible as per the religion. Thus, the adoption of this form of insurance spread through the Arab world through foreign agencies. Morocco was predominated by Spanish companies, Yemen and Sudan had various British insurers and the Libyan market was primarily served by Italian entities.

However, as Arab states began to gain independence, many of these foreign entities were converted to national insurance companies due to the unresolved issues of interest bearing investments by insurance companies. This form of investment directly contradicted the teachings of Islam. Differing views by Islamic scholars paved the need and demand for Islamic faith based solutions, that offered insurance services, but in a religiously compliant manner.

By 1960, the number of companies in Arab states was 723, with 668 foreign companies and only 55 national companies. By 1996, there were 293 insurance companies, with only 74 foreign companies and 219 national companies. Many of these national companies began converting the insurance and banking system to be in line with faith based practices, excluding practices related to gambling, prohibited goods, interest and speculation[l]. The first ever Takaful insurance company thus opened in 1979 in Sudan[li]. The first truly recognized Takaful company in Malaysia opened in 1985 following the passing of the Takaful Act in 1984[lii].

1.3 - The Historic Context for Canada

Today, the world (and Canada) is no stranger to the concept of faith based insurance. Similar risk sharing models exist for various religions such as Christianity and Judaism. Christian associations have existed since the late 1700's. Current examples include Catholic Financial Life, Polish Roman Catholic Union, and Catholic Knights, where surplus proceeds are invested in activities in line with the teachings of the Catholic Church, and priests/bishops/cardinals are appointed as spiritual directors on the board[liii].

Given the history of faith based insurance, it should be of no surprise that the concept of insurance itself has a longstanding history. Surprising to some however, is that the roots of insurance actually stem from the Arab world itself. Originating from the Middle East, insurance was once again introduced in the early 20th century, and experienced resurgence from its prior format in the 21st century. While many view the concept of Takaful as a foreign and unfamiliar form of insurance, understanding insurance from an historic context demonstrates that not only does insurance stem from the Arab world, but that the mutual model of Takaful is one that has existed for many centuries.

Canada's close familiarity with faith based insurance and mutual insurance makes Canada a prime market for the entry of Takaful. Stemming from the need of farmers in the 1800's[liv], mutual insurance has existed in Canada since then. The rapid growth of modern day for-profit insurance took place because of growing demand for insurance. Today, with an overwhelming number of insurance companies and fierce competition, the growing demand for faith based insurance such as Takaful once again provides a growth opportunity for the insurance sector.

SECTION 2: TAKAFUL - THE CHALLENGING ROAD AHEAD

Through history it can be seen that divergence in insurance comes from a differing business goal; joint coverage of policy holders versus profit maximization for the operator. Where mutual insurance has been successful because of like-minded individuals seeking shared coverage, it risks morphing into a for profit model as demand increases and operators see greater market potential. In this light, it is important to consider that the growing demand of a group of Muslims in various jurisdictions around the world has once again created a demand for joint coverage models, but it also risks turning into a for profit model overtime. Thus, in order to protect the original intent of Takaful, it is important that it be regulated to do so in these various markets.

The Islamic finance sector was worth an estimated $1.8 trillion dollars in 2014. Of that, banking represented 73% while insurance only represented 2% ($33 billion)[lv]. Despite reports of rapid growth in the sector, it is important to remember that the sector is still nascent.

Factors such as the existence of mutual insurance, favourable credit ratings, large Muslim population and growing GDP make Canada an attractive market for growth of the Islamic insurance sector. However, there are many challenges and issues currently faced by the sector that need to be considered prior to market penetration. A literature review and expert opinion interviews revealed that despite the potential attractiveness of the uniqueness of the product (due to surplus returns), Takaful in practice is plagued with issues, some of which are being experienced globally. Many of these challenges can be faced in Canada. The following provides insights into some of these findings.

2.1 – Stigma

Despite continuous growth, the market awareness of Takaful is low from a global perspective. According to a Senior Takaful executive with experience in Nigeria and Sri Lanka (I2)[lvi], lexicology plays a large role in lack of awareness and interest[lvii]. From the perspective of a retired CEO of a large Takaful operator in the Middle East (I2[lviii]), the word Takaful itself is an issue in attracting the non-Muslim population. The utilization of an Arabic word to describe a familiar mutual insurance product limits it marketability globally. I1 further identified that given the relative youth of formalized Takaful in the Asian continent, people are just not familiar with the concept because they are very used to conventional insurance[lix].

Furthermore, given the current association between terrorism and the Islamic religion, the term ‘Islamic Insurance’ does not provide any benefit to marketability beyond the Muslim population. It suggests that the product is designed to meet the needs of individuals who identify with the Islamic religion. Potential non-Muslim customers may be hesitant to associate themselves with a perceived religiously tied product, when the religion does not match their own, or match their spiritual views. In essence, the religious association of the product makes it less attractive, and imparts a sense that that the product is meant only for those that follow the Islamic religion.

This however can be far from the truth. Sri Lanka proves to be an interesting case study. Takaful was launched in 2000 in Sri Lanka via Amana Investments Ltd[lx]. Through dedicated marketing efforts, in one decade, 15% of the population held Takaful policies, while less than 10% of the population are actually Muslims[lxi] (this is relatively low for an Asian country). In a research survey interviewing five Sharia scholars, many respondents highlighted that in order for the Takaful industry to exceed expectations, knowledge of Takaful should be promoted and is of paramount importance to the success of the product globally[lxii]. As indicated by I1, Takaful has been successful in Sri Lanka because the benefits of the product (over conventional products) was the focus of marketing initiatives, and not the religious compliance of the product itself[lxiii].

2.2 - Investment of Funds

Given the requirement that funds not be invested in interest bearing instruments or from sources that derive revenue from restricted products such as alcohol and armaments, the actual investment of funds can be restricted to just a few options. For this reason, Takaful companies tend to be dangerously over invested in real estate and Islamic banking securities. I2 shared that this phenomenon has been experienced in various jurisdictions, but its shortcoming can been highlighted in Dubai, where the real estate markets crashed after the 2008 global recession, and almost every Takaful operator reported large losses because of their over exposure to real estate investments[lxiv].

Various jurisdictions have come up with Sharia compliance indices to help alleviate the issue, but similar to ‘green indices’, Sharia compliant indices don’t necessarily indicate anything about the performance of the security[lxv]. It merely helps in the marketability of compliant stocks and companies that may be potential investments. Furthermore, given the relatively small market size of the Islamic financial sector, there aren’t many options for Sharia investments in the first place[lxvi]. In the spirit of diversification of risk, I3 shared that many fund managers may simply have no choice but to invest in underperforming securities, or risk being over exposed to certain market risks[lxvii].

Finally, when it comes to actual investment and returns, there is no central format for reporting and thus comparing results between operators can be quite difficult and a high degree of trust is needed. For example, I1 shared his knowledge that a Middle Eastern operator with a loss of $120 million dollars hid this from policyholders by dividing the loss over four years through accounting manipulation. The operator was later exposed as to having actually hired and fired two international leading audit firms to support their untruthfulness. The auditors risked getting fired if they didn’t comply with the wishes of the large operator, partly owned by a ruling family in the Middle East[lxviii].

2.3 - Demutualization can lead to erosion

Takaful has been identified by some as a solution to the demutualization issue faced in mutual insurance[lxix]. That is, when mutual insurance companies experience shortages in capital or their growth is restricted, they look to shareholder investments, in effect, demutualizing the company[lxx]. Since Takaful is based on risk sharing (much like mutual insurance), and it offers outside funding through its hybrid structure, the Canada Islamic Finance Outlook Report of 2016 identifies Takaful as having an opportunity in Canada to address the mutual insurance issue without demutualizing the company[lxxi].

However, it is worth noting that its actual application may be different than expected. In practice, the losses of badly run Takaful companies can get quite large, and the operator loans come to a point of a likelihood of non-repayment. As this event takes place, the operator will likely exchange debt for ownership, making the company structure more similar to a traditional shareholder owned model[lxxii]. In this light, while the hybrid structure of Takaful allows outside funding without significant erosion of mutual values, the same benefit also acts as a double edged sword in the event of loss and leads the to the very demutualization issue it sought to rectify.

2.4 - Dispute Resolution

In developed Islamic Financial jurisdictions like Malaysia, Takaful disputes are commonly settled in civil and common law courts, similar to Islamic financial transactions. This may be problematic given the lack of precedence (for common law) and that there may be a misapplication of Sharia law in non-Sharia jurisdictions[lxxiii].

Dispute resolution often relies on expert opinion provided by Sharia scholars, which in practice can vary depending on various factors such as religious sect, cultural practices and so on[lxxiv]. In Malaysia and Singapore, there have been large efforts by the government to address this issue and spur development through legislative formalization. According to I1, in other jurisdictions however such as Nigeria and Sri Lanka, lack of advanced formalization provides little context for disputes to be compared and settled[lxxv]. In the event that Takaful insurance enters the Canadian market, without clear legislative recourse, the first few years may give rise to issues that will not be easily settled.

Furthermore, since the application of law varies from jurisdiction to jurisdiction, international companies operating in multiple markets may face issues in their assumptions about compliant practices[lxxvi]. This ambiguity poses significant risk for large operators to consider expanding globally and I3 identified this (paired with the shortage of skilled labour) is the largest impediment for his firm's market expansion plans[lxxvii].

2.5 - Human Resource Shortage

Given the relatively limited geographic scope and age of modern day Takaful, finding skilled staff is a real and challenging issue for the sector. For Boards and operators, it requires staff familiar with risk management, insurance and Sharia (at a minimum). For Sharia Advisory Committees, it requires finding Islamic scholars who are also familiar with insurance concepts. Secondary research identified that the issue of lack of talent has resulted in extremely high labour costs[lxxviii] and I2 also identified that this has also resulted in extremely poor customer service standards[lxxix].

While the Malaysian banking sector has formed alliances with universities following direction from Bank Negara Malaysia[lxxx], growth in other jurisdictions may be severely limited due to lack of formal training programs. In Canada for example, there are no official university programs teaching Islamic finance or Takaful. Certain schools offer single courses in Islamic finance (such as in University of Toronto's MBA program taught by Professor Walid Hejazi)[lxxxi], but for Toronto to take on a leadership position as a central North American hub, full programs will need to be in place to attract foreign talent and also to develop local talent.

Since employees sit at the heart of any business, the issue of lack of talent can have a profound impact that limits the success of any business[lxxxii]. For Takaful, both I1 and I2 shared their views. It could mean that Sharia Advisors with no knowledge of insurance may be put in positions that consistently create conflict between Board members[lxxxiii]. It could mean that poor performance by staff may continuously be rewarded in an effort to retain them[lxxxiv]. It could also mean that attracting talent from other countries will require large investments such as lengthy Visa applications along with cross market training, at the risk of a competitor poaching the individual shortly thereafter[lxxxv].

2.6 Sharia Advisory

There is a significant issue faced with the 'Sharia compliance' nature of Takaful. Since operators are required to invest in an ethical manner, it requires the development of a Sharia Advisory Committee, consisting of Islamic scholars[lxxxvi]. I2 expressed that these Sharia scholars may have very different views since they are not required to operate a business, but rather provide religious insight which can often times be contrary to the views of the Board of Directors. This not only poses time lags in bringing products to market, but it also causes severe ethical concerns and conflicts of interest. For example, given the shortage of Sharia scholars, many scholars sit on multiple boards for multiple companies in the same industry[lxxxvii].

Furthermore, many Sharia scholars, trained in Islamic law, know very little about the insurance business itself. In a recent exploratory research study conducting interviews with Sharia scholars sitting on advisory boards, most respondents reported that they were not exposed and were not familiar with the underwriting and risk rating practice in family Takaful[lxxxviii], yet they are elected as advisors in insurance matters and possess the powers to accept or reject product development and market strategy (as indicated by I2)[lxxxix].

Reports of inconsistency also exist. Many Sharia scholars disagree with one another based on sect, culture and school of thought. For example, there isn't a generally accepted practice related to nominations in the event of death. Some scholars argue that a nominated individual at the time of death can only be a family member, and an insurance plan is an asset that belongs to the deceased (and thus his/her family). Others argue that insurance plans are not assets, and non-related nominees should merely act as executors[xc]. Even still, I1 shared that there are some scholars who believe that insurance itself (in any form) is against the Islamic religion while various other scholars approve Takaful as an acceptable alternative[xci].

The lack of consistency between scholars has led to a phenomenon known as "Fatwa Shopping" where scholars are selected and unethically paid, based on their agreement with the intent of the Takaful operator[xcii]. For example, I2 expressed that in the case of a large Takaful operator in the Middle East, a major national airline carrier requested coverage. Given that some proceeds are generated from alcohol sales, the operator feared losing the account by offering a product that covered all aspects of the business except for anything related to alcohol (as recommended by their Sharia Advisory Committee). In an effort to not lose the business, the operator paid another Sharia scholar to approve a model whereby the entire operation could be insured based on the concept that the airline is not in the business of generating primary sales from alcohol, but rather from travel, thus the minimal amounts generated from alcohol could be ignored and insured, per Sharia approval of the scholar[xciii]. In this light, the lack of consistency has given rise to the ability to cherry pick scholarly views that align with those of the business, in effect, minimizing the role that scholars actually play in the sector, and the intent of the product in the first place.

2.7 – Competitiveness

Despite Takaful's rapid growth, there have been reported issues related to the high operational costs of companies and lack of competitiveness in the market. For example, despite distinct Takaful legislation in Pakistan, where there is a majority Muslim population, the adoption of Takaful is below 1%. This has been largely attributed to the lack of competitiveness of product offerings in the market[xciv] compared to regular insurance products.

High costs come in the form of factors such as unregulated agency fees and profit sharing ratios (a common hybrid model utilized to pay Takaful operators). In some cases, the agency fees can be as high as 40% and in many instances, profit sharing is based on surplus leftovers versus profit[xcv]. In the surplus model, policy holder's contributions themselves go towards the Takaful operator which also poses an ethical issue. According to an exploratory research project with Takaful operators, interviewees reported that they (Takaful operators) take excessive profits and pay themselves first[xcvi].

According to I1, Other cost drivers could include high cost of skilled labour (given the high demand and shortage of supply), and high costs of marketing to educate the public[xcvii]. According a recent study by A.M. Best special's report, Takaful operators are struggling with issues of growth and profitability, and the report recommends that given the agency/profit sharing model, regulations are needed to strike an adequate balance of earnings to agency fees[xcviii]. In a presentation by Bank Negara Malaysia to the government, it was reported that expense ratios of Takaful operator are consistently higher than conventional insurance providers and it has resulted in a perception that Takaful is a more expensive option[xcix].

2.8 – Retakaful

According to I3, the availability of retakaful (reinsurance) is a major concern for most operators[c]. There are only a few large reinsurance operators globally, and it wasn't until recently that they launched retakaful arms. According to I1, it questions whether the operations of such reinsurance companies are truly Sharia compliant or if it is simply a branding effort to fulfil a market need[ci].

I1 shared that in the past, where retakaful was not readily available, Sharia scholars approved reinsurance solutions (in lieu of retakaful solutions) based on the "law of compulsion". Under this concept, a business is compelled to accept non-Sharia compliant reinsurance because of the lack of availability of retakaful as an option[cii]. I3 thought that given that retakaful and reinsurance is a necessary risk management and expansion tool, it questions the efficacy of Takaful (with regular reinsurance) as a faith based insurance product[ciii].

Identifying an increasing global demand for Takaful products, I3 further expressed that the issue was similar to the 'chicken and egg problem'. There is just not enough demand to offer products yet. On one hand, reinsurance companies are exploring potential retakaful offerings in the market, but the lack of adequate demand prevents them from launching full windows. On the other hand, insurance companies complain that the lack of retakaful options prevent them from launching their own Takaful products. I3 also expressed that reinsurance companies view the market as being so small, that first mover benefits do not outweigh the legal and business risks associated with an immature market that has yet to reach an adequate point of equilibrium[civ].

2.9 Regulatory Environment

The existence of Takaful requires a supporting legal and regulatory environment in which to operate. Most regulatory environments have been historically developed to suit for profit insurance. Changes to statutory frameworks take time and limit market readiness[cv]. Various jurisdictions around the world are at differing points in their regulatory lifecycle in the evolution of Takaful adoption. Looking around the world, it can be seen that no one single market provides an adequate frame of reference for Canada, but rather, looking at the differing points that each market is at provides some insight into thematic challenges.

For example, in the largest Takaful market, Malaysia, growth in the sector wasn't seen until the formal introduction of the Takaful Act in 1984. Even then, almost 32 years later, Bank Negara Malaysia still continues to update its regulatory environment to cover topics such disclosure, operating flexibility, delivery channels and market practices[cvi]. This reflects that the existence of a single overseeing agency can provide valuable and skilled based updates to support the evolution of the regulatory environment overtime.

In Saudi Arabia, despite regulations being introduced in 2004, reserve requirements are only now being enforced, based on actuarial studies. Bahrain is also in the process of enhancing its framework for solvency positions of Takaful and retakaful operators[cvii]. This suggests that Takaful may be needed to be treated differently from typical insurance (in terms of reserve requirements).

The United Arab Emirates introduced regulations in 2010 that prohibited conventional companies form offering Takaful products through Islamic windows. They also are enforcing stringent requirements for operational Sharia compliance and transparency in distribution of surpluses[cviii]. This shows that reporting requirements vary, but an explicit reporting standard is of importance to ensure transparency.

In Oman, restrictive regulations for Takaful entrance was only lifted in 2011 despite the popularity of the product in the neighbouring regions. Their regulations require that operators must be publicly traded with minimum capital requirements and the Omani government has also introduced a Sharia compliance index to support investment activities[cix]. This not only reflects that regulatory environments need to be updated to allow for the entrance of Takaful, but also that Takaful capital requirements are not the same as for-profit models, and regulations need to accommodate for both models.

Finally, in the more mature market of Indonesia, capital requirements have been hindering growth, so the government is introducing new legislation to spur mergers of smaller units. The new laws also cover areas such as licensing, market conduct, corporate governance and consumer protection that will be industry wide (covering both conventional and unconventional insurance)[cx]. This reflects the challenges with product delivery and sales conduct, and that a supporting regulatory environment is needed to protect business and consumers.

Through secondary research and through the interview process, various issues were also uncovered that require regulatory compliance oversight. But with laws and rules in place, the enforcement of them is also necessary. For example, I2 shared that the redistribution of surplus profits is not a common practice in the Middle East, despite the product offering and promise to do so. It is only recently being investigated by regulators (as of 2015)[cxi]. This complaint has also been heard in the more mature markets of Malaysia and Indonesia. Literature reviews have also demonstrated a lack of transparency in the distribution of surpluses, exacerbated by a lack of standardized reporting requirements[cxii]. Additionally, despite risk management controls, it appears that many Takaful operators have been in recovery mode following huge losses from risky reliance on securities prior to the global financial crisis of 2008. As I2 shared, his experience is that losses haven't been reported despite verification from auditors[cxiii].

SECTION 3: RECOMMENDED APPROACHES AND CANADIAN CONSIDERATIONS

The purpose of reporting issues faced by the Takaful sector is to identify challenges so that they can be addressed in Canada. As Canada positions Toronto to become a central hub for Islamic finance in North America, these challenges provide considerations for successful implementation of Takaful in Canada. Indeed, much like Malaysia, we will likely see an evolving regulatory regime, but these issues can largely be addressed through market and regulatory activities. Recommendations are thus outlined as follows.

3.1 - Stigma

To overcome the issue of stigma, there needs to be a concentrated effort by all Islamic insurance players to educate the public on the benefits of Takaful in their own local markets. Given the multicultural nature and diversity of the Canadian population, this may stimulate demand and awareness within Canada by its travelling residents. I1[cxiv] and I2[cxv] both identified that the responsibility lies primarily with the operators themselves, as a cost of doing business.

I3 identified that this responsibility also extends to government through endorsements of products and allowing licensing of foreign entrants into the market[cxvi]. In Canada, players like Sunlife Financial and Manulife Financial have operating experience in Southeast Asia as well as a long history of Mutual insurance[cxvii]. Their experience should be leveraged in Canada so that targeted sectors of the population may first be catered to, followed by larger public offerings.

The government should also make provisions for offerings through banks as a sales venue (bancassurance) to provide legitimacy and confidence in financial stability of the insurance provider. However, the practice of forcing paired services on to customers should be banned with the purchase of Takaful products (i.e. the bank should not force its customer to buy their products in order to purchase Takaful products).

All interviewees responded that most importantly however, the terminology of Takaful and Islamic insurance should be updated to reflect a spiritual or ethical approach that is pan-Canadian. ‘Ethical Insurance’ may be a more appropriate term for the Canadian market. The concept of ethical insurance and socially responsibly investments is one that Canadians are already familiar with[cxviii]. Awareness that insurance stems from the Arab world can help alleviate some concerns as to the sophistication of the product.

3.2 - Investment of Funds

The lack of available Sharia compliant options make investment of funds a challenge. In order to successfully increase the availability of such funds, the Canadian government will need to actively open up global opportunities and options, and also promote the development of Sharia compliance indices (as is the case in Oman). Global options such as investment in Islamic banks, linking to foreign stock exchanges (such as the Dubai International Financial Exchange) and opportunities to purchase Sukuk bonds (Islamic bonds) in Toronto will not only create opportunities for Sharia investment, but will also spur the development of the Islamic financial hub envisioned, much like London in the United Kingdom.

According to I2, Takaful operators are both funds managers and insurers and laws must reflect this[cxix]. Firewalls should be required to avoid conflict of interests and provide clear separation. Furthermore, Sharia compliance provisions should be put into place, inspired by current securities provisions[cxx]. Sharia compliance specialists will be needed at securities commissions in order to achieve this.

3.3 - Demutualization leading to erosion

Given Canada's history of mutual insurance, Takaful can offer a solution to the demutualization issue faced by insurance companies[cxxi]. However, care must be taken and further research should be conducted into the area of appropriate levels of operational deficiencies to develop adequate regulation.

The intent is to prevent reverse shareholder takeover by the operator to maintain the ethical integrity of the product. In other markets such as Malaysia, the government has developed specific regulatory considerations in the event of deficiency and the need to wind down business[cxxii]. The International Association of Insurance Supervisors suggest that insolvency frameworks need to consider the uniqueness of Takaful structures in that policy holders interests should be protected first and foremost and in some cases, extended to establish how far cross pools are responsible for other pools[cxxiii]. It may also require ranking of policyholder dues above operator dues, or may require regulations for unique coverage ratio's that transparently reflect deficiencies to be treated as liabilities (despite a concurrent increase in asset value from a loan cash injection).

3.4 - Dispute Resolution

As I1 and I2 shared, to address the issue of dispute resolution, Malaysia has adopted an interesting model which is a recommended solution for the Canadian market[cxxiv]. The regulator developed a dedicated division in its high court to address dispute resolution related to Sharia issues. Furthermore, Malaysia established a separate entity comprising of Sharia scholars at the national board level to provide insight and expertise on Sharia compliance issues. In the case of disputes, cases continue to go through the common law system, but non-binding recommendations are solicited from the national Sharia Advisory Board[cxxv].

A structure like this would work well in Canada, where the existence of administrative tribunals is a familiar concept in various sectors such as transport, insurance, securities and energy. The development of an independent Sharia Advisory Board could also pose other advantages, if enacted, to develop awareness in the sector, compliance, provide standardized opinions on matters, address disputes, and enhance educational programming. The goals and responsibilities of this independent regulator would have to be enacted in law to give authority to the body.

3.5 - Human Resource Shortage

Given the shortage of professionals globally, institutional and academic collaborations is necessary for the development of talent in the sector. Government support, grants, research funding, can all aid in the long-term development of the sector. Furthermore, creation of executive level certification and Sharia scholar certifications can also aid in assuring consistency of skills and labour.

The UAE and Malaysia can act as models for development in this sector. According to the Canada Islamic Finance Outlook Report (2016) and the interview with I2, the UAE has addressed the issue of labour shortages by creating a conference hub in the Middle East on the topic of Islamic finance and positioning itself as an expert in this arena[cxxvi][cxxvii]. As I1 shared, operators support R&D in the sector by supporting university programming and sponsoring these large conferences that attract global players. Additionally, Malaysia has forged formal alliances with universities following direction from its national bank. Both models would work in the Canadian context through directive power via the government.

3.6 - Sharia Advisory

The issue of Sharia advisory is a significant one. Lack of harmonization and agreement amongst scholars is a global issue and needs to be addressed at a national level (global boards are unlikely to develop in the current market). To provide an example, the development of a national board in Malaysia has been identified as having paramount importance to the overall development of the sector due to the reliability of one single source and the national bank and the government are actively working on a formal single body[cxxviii].

The structure of the National Advisory Board may be done in a manner that reflects not only various functions of the Islamic finance sector through business representation (including of course insurance) but may also be designed to reflect various sects and cultural backgrounds within the Muslim community itself. Thus, board representation may be made up of cross industry professionals, along with scholars representing various religious sects such as Sunni and Shiite scholars. In this manner, majority member's board rulings can provide an adequate governance structure to the country or province.

In relation to skill levels of Sharia advisors, it can be made compulsory that scholars also become licensed in insurance during their time sitting on internal institutional committees. The funding for this could be subsidized by the government until a time when confidence in the profitability of Takaful operators can be maintained or it could simply be absorbed by the operator as a cost of business. This advantage of insurance training to scholars is so that they become better versed and familiar with the business they are advising on.

In terms of governance, it may be worthwhile to ensure that every Takaful operator have a minimum number of Islamic scholars as official corporate board members. This helps to reduce the conflicts that may exist between board directors and scholars, while also helping reduce the issue of 'Fatwa shopping' since the CEO alone may not hold sole power in choosing scholars that meet company objectives and opinions.

3.7 - Competitiveness

The lack of transparency in the sector and lack of regulation of commissions/profit sharing structures can be seen as a large contributor to unprofitability in the sector. In relation to transparency, it is prudent that Canada maintain reporting standards in line with global development. Currently, the Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions provides guidance and leadership on reporting. This can help alleviate issues where operators fail to distribute surpluses or keep majority of the surplus as fees. It can be a requirement that operators in Canada follow the guidelines of International Financial Reporting Standards and also of the agencies listed above. Offering to host satellite offices for these agencies can help to attract the expertise in Canada (the UAE has followed this model in the development of its renewable sector).

In terms of operator fees/commissions/profit, it is important that Canada conduct research and take a stand on the issue of surplus sharing versus only profit sharing. There is globally differing views on whether an operator has the right to take agency fees from only profits generated, or from any surplus that exists at the end of the term (even if the surplus included contributions from policyholders). This issue is common in mutual funds, where fund managers deduct their Management Expense Ratio (MER's) fees regardless of profits generated. In Canada, a level playing field will need to be established for current insurance providers and thus research should be conducted into this consideration, as it will have a large impact on competitiveness of Takaful versus traditional insurance.

Furthermore, research into appropriate levels of agency fees, and limits on them, will provide more structure to an ailing sector. Covenants in the form of expense ratios may also be imposed if deemed appropriate. Other regulation can also be considered such as limiting agent commissions. In Malaysia for example, Takaful brokers make more money per sale versus conventional insurance despite lower profitability in the sector[cxxix]. There is surprisingly significant research on this topic conducted by Bank Negara Malaysia and this can help provide a platform for Canada to base its decisions on.

3.8 – Retakaful

Given that Canada currently has 306 insurance companies as of 2016, the availability of reinsurance may not actually be a significant issue. Most of the reinsurance companies present in Canada have global presences and most already offer retakaful services in other markets[cxxx]. As per I3, the offering of these retakaful services is simply dependant on direction from the government for firm intention and commitment to development of the sector. To ensure Sharia compliance of retakaful service providers, updates to reinsurance regulations will be needed.

3.9 - Regulatory Environment

Updates to the regulatory environment are numerous and specific in nature. For the purpose of this paper, high level recommendations are being suggested.

The advantage of Canada is that it has a history of mutual insurance and thus, legal infrastructure is already in place. As I1 expressed, Canada will need to look at additions and updates to sections of regulations through the regulator, rather than a cumbersome process updating legislative law[cxxxi]. This means that Canada's regulatory barrier to entry is relatively low compared to other jurisdictions and Canada is well positioned for Takaful.

In terms of regulations, Canada will need to focus on three key areas: governance, prudency and solvency, and market operations. Bank Negara Malaysia provides an excellent starting point for Canada to consider in making these updates. It provides various documents that outline the path of its regulatory journey, along with a blue print for international expansion and internal regulatory outlooks.

Furthermore, there are various recommendations in place from the Islamic Financial Services Board that address regulatory updates from the perspective of the International Association of Insurance Supervisor's Insurance Core Principles[cxxxii]. This approach provides a systematic framework for updates in related core principles.

In identifying directions for the regulatory environment, the following chart[cxxxiii] summarizes some thematic issues to address through the regulatory process related specifically to Takaful.

Governance

- Existence of a Sharia Advisory Committee and conflicts of interest
- Fiduciary responsibilities
- Duties of Board, Senior Management, Acctuaries and Auditors
- Transparency and reporting

Prudentials

- Rules for safekeeping of assets and diverisification
- Investment limits, risk management, stress tests
- Solvency, capital and reserve requirements
- Investment in Sharia compliant instruments
- Rules surrounding managmeent of PA and PSA
- Accounting Treatements
- Retakaful requirements
- Repayment of Loans to operator in the event of deficiency

Market Conduct

- Disclosure, presentation of reports
- Transparency
- Seperation of funds
- Disclosure of agency fees and profit sharing ratios

For a Western country, some of the regulatory issues mentioned earlier may seem unethical, but in markets with less supervision from the regulators, the risk of falsified information can be much greater. From a Canadian context, the approaches taken by other global jurisdictions provide anecdotal evidence for what could possibly go wrong, and provide an overview of further issues that will need to be addressed. Since there is no one jurisdiction in the world with a long standing regulatory environment for Takaful, Canada will have to look to all jurisdictions around the world to see what lessons can be gleaned, and follow in the footsteps of Malaysia by enacting an independent regulatory agency that continues to evolve and better the regulatory environment.

CONCLUSION

We have come a long way since the original conception of insurance in ancient times, yet, the journey of insurance has ironically led right back to the start. The growth of Takaful and Islamic finance is rapid and keeping up with changes in the sector is difficult. Canada's decision to position Toronto as a financial centre is smart, given that more than 50% of Canada's Muslim population live in Toronto[cxxxiv].

Takaful adoption and the regulatory environment that supports it is unique to each market. While Malaysia, Indonesia and United Arab Emirates provide an overview on how these rules and regulations can evolve over time, other markets like Pakistan show shortcomings when a product can't be competitive in the market.

For Canada, given that auto insurance is compulsory and prices continue to rise, consumers may be looking for alternatives to traditional models. While Takaful is not a revolutionary concept, it can be marketed as an innovative product that may be of interest to many consumers, given the possibility of a surplus return.

In order to penetrate the market, various recommendations have been made in this paper, but a recommendation to rebrand Islamic insurance is perhaps one of the most important ones as a start. Perhaps Canadian's may respond better to 'Ethical Insurance' rather than 'Takaful' or 'Islamic insurance'.

Canada's exploration into Takaful is commendable. But had Canada failed to do so, it might have been an area that the country would have lagged behind in because there is undeniable evidence that Islamic finance is growing at a rapid pace. The growth rate and market size of Takaful has not kept up with that of Islamic finance, but research suggests that it may largely be due to lack of industry standardization. This comes in the form of accounting standards, transparency standards and Sharia standards. Overcoming these issues will require a diplomatic approach, paired with leadership. As Islamic finance and Takaful enters the Western world, the regulatory structure will have to evolve to meet the needs of an 'east meets west' approach. Perhaps Canada is the only country positioned for this in North America, given its diversity and inclusionary culture.

This paper explored the history of Takaful, along with the challenges and issues faced in jurisdictions around the world. It was meant to be a market primer for early considerations. There is however limitations to the research conducted. Firstly, there is a lack of reputable literature available on the topic and lack of quantifiable data available. Secondly, while 3 expert interviews were conducted, they were by no means meant to provide a representative view of the world. Rather, they were conducted to glean expert opinion on various issues uncovered.

While this paper introduces concepts and challenges that must be addressed prior to Takaful's entrance into the market, it paves the way and identifies the need for significant regulatory research. As next steps, it is prudent that research be conducted into regulatory challenges and procedures around the world, alongside an analysis of the Canadian regulatory environment by province (with a focus on Ontario first). Through this, the building blocks of a consultative regulatory update can be developed for the

Canadian government and the Financial Services Commission of Ontario. Using the Ontario model, products can then be rolled out to other provinces under the guidance of the Office of the Superintendent of Financial Institutions. Furthermore, research and focus group testing should be conducted to determine the appropriate title for Takaful in the Canadian market. While this paper suggested “Ethical Insurance”, there is no statistical evidence of how this will be received by consumers in Canada.

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