ISLAMIC FINANCE BREAKFAST EVENT
April 2012
“INTRODUCTION TO ISLAMIC FINANCE”

PRESENTATION BY: ASHAR NAZIM
ISLAMIC BANKING EXCELLENCE CENTER, ERNST & YOUNG (BAHRAIN)
Agenda

1. Why Islamic finance?
2. How is it different?
3. Islamic banking products / IFRS vs. AAOIFI
4. Regulatory and Shari’a perspective
5. The South Africa opportunity
Globally, Islamic finance is here to stay
From an untested concept in 1950s, to mainstream industry in several core markets today

**Challenge**
- Contemporary financial system practices were in direct conflict with religious beliefs of ~ 20% of the world population
- Strong desire to move towards ethical banking
- Niche industry at inception

**Opportunity**
- Oil wealth in GCC
- Successful roll out in populous markets (like Malaysia)
- Ongoing global economic meltdown

**Situation Today**
- More than 450 financial institutions offering Islamic finance
- Across 75 countries
- $1 trillion in assets; growing @ 15-20% per annum over the past decade
- Growing acceptability across mature and frontier markets; Africa is primed to be the next growth market for Islamic finance
Globally, Islamic finance is here to stay
Islamic finance assets with commercial banks alone are set to reach $1.1 tn by 2012

Source: IMF, The Banker, Central Bank Websites, EY perspective
Drivers of growth
Growth is being fueled by a number of factors

- Increasing Propensity for Shari’a Compliant Finance
- Oil Revenues of GCC States
- Muslim Population Growth
- Role of Enabling Institutions
- Regulatory Reforms
- Diversification Efforts
- Acceptance by Conventional Institutions
- Government Support
Role of enabling institutions

Infrastructure and multilateral institutions are trying to address some of the challenges facing Islamic finance industry.

AAOIFI
(Accounting and Auditing Organization for Islamic Financial Institutions)

IFSB
Islamic Financial Services Board

IIFM
International Islamic Financial Market

IDB
Islamic Development Bank
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1. Why Islamic finance?

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4. Regulatory and Shari’a perspective

5. The South Africa opportunity
Key difference with conventional banking
Shari’a filter sets Islamic finance and banking apart from conventional finance – it is the reason for existence of Islamic finance industry
Key difference with conventional banking

Islamic finance is based on the underlying principles of Islamic economic system

- **Asset backed**: Transactions must typically be backed by assets. No returns on lending of cash

- **Interest free**: Payment / receipt of interest is prohibited. Profit is encouraged

- **Restricted investments**: Investments, or the tangible assets backing investment instruments, should not belong to prohibited industries (e.g. alcohol)

- **Opacity/extreme uncertainty**: Extreme uncertainty and/or lack of transparency (Gharar) is prohibited, as is gambling

- **Risk-sharing**: Based on the principle of assuming risk to obtain rewards to foster justice in transactions
Key difference with conventional banking
Shari’a filter sets Islamic finance and banking apart from conventional finance – it is the reason for existence of Islamic finance industry.
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Islamic financial contracts

Islamic products can be structured using various underlying Islamic contracts (each with different risk implications)

- Debt like Instruments
  - Murabaha
  - Ijarah
  - Salam
  - Istisna

- Equity like Instruments
  - Mudarbah
  - Musharakah

- Sukuk
Islamic financial contracts

Different contracts allow for products having different sets of features

- **Murabaha**: Trade with declared markup or cost plus sale
- **Mudaraba**: Profit sharing agreement
- **Musharaka**: Equity participation
  - **Diminishing Musharaka**: Equity participation with phased reduction
- **Ijarah**: Renting for beneficial use
- **Salam / Parallel Salam**: Deferred sale contracts
- **Istisna’a / Parallel Istisna’a**: Construction / project finance
Islamic contracts and applications

Islamic products can be structured using different contracts. The contract used will depend on bank objectives, regulatory requirements and market dynamics.

- **Consumer Banking**
  - **Consumer Assets**
    - Home Finance
      - Murabaha
      - Ijarah
      - Diminishing Musharaka
      - Istisna’a
    - Auto Finance
      - Murabaha
      - Ijarah
      - Diminishing Musharaka
    - Personal Finance
      - Tawarruq
      - Ijarah
      - Salam
    - Credit Card
      - Ijarah
      - Tawarruq
      - Qard
  - **Consumer Liabilities**
    - Savings Account
      - Wakala
      - Mudaraba
    - Current Account
      - Qard
      - Mudaraba
    - Investment Account
      - Wakala
Islamic contracts and risks
Different types of Islamic contracts attract different kinds of risk

<table>
<thead>
<tr>
<th>Islamic contract</th>
<th>Credit Risk</th>
<th>Liquidity Risk</th>
<th>Market Risk</th>
<th>Equity Risk</th>
<th>Asset Risk</th>
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<tbody>
<tr>
<td>Murabaha</td>
<td>✗</td>
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<tr>
<td>Ijarah</td>
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<td>Mudaraba</td>
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<td>Diminishing Musharaka</td>
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# Accounting standards for Islamic financial institutions

**Why are specific accounting standards required for Islamic finance?**

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<thead>
<tr>
<th>IFRS</th>
<th>Give guidance on, amongst others, how to:</th>
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<tr>
<td></td>
<td>► Carry out accounting treatment for transactions; and</td>
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<td>► Report and disclose financial position or performance</td>
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<table>
<thead>
<tr>
<th>AAOIFI</th>
<th>Give guidance on, amongst other, how to:</th>
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<tbody>
<tr>
<td></td>
<td>► Carry out accounting treatment for transactions;</td>
</tr>
<tr>
<td></td>
<td>► Ensure that transactions are Shari’a-compliant;</td>
</tr>
<tr>
<td></td>
<td>► Report and disclose financial position or performance;</td>
</tr>
<tr>
<td></td>
<td>► Deal with revenues and expenses that are not Shari’a-compliant; and</td>
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<tr>
<td></td>
<td>► Determine basis for Zakah calculation</td>
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Accounting for Islamic finance places emphasis on:

- actual structures and flows of Islamic finance transactions – to help determine Shari’a compliance; and
- financial effects of those transactions

Accounting treatment for Islamic finance transactions has impact on Shari’a compliance aspects of those transactions
AAOIFI vs IFRS

**Leases**

- **Lease Period**
  - **Owner (Lessor)**
  - **Risk and Rewards of Owner (Lessor)**
  - **User (Lessee)**
  - **Risk and Rewards of User (Lessee)**

- **End of Lease**

- **Rentals** booked as expense by lessee and income by lessor
- **No concept of principal repayments**
- **At the end of lease term ownership can transfer under a separate contract**
- **Under IFRS these two contract shall be treated as finance lease (based on economic substance)**

**Transfer of Risk and Rewards of Ownership**

- **Owner (Lessor)**
- **User (Lessee)**

**Against a Defined Consideration**
**AAOIFI vs IFRS**

**Investment properties**

- **Investment property at fair value**
  - **AAOIFI**
    - Gain goes to P&L
  - **IFRS**
    - Gain goes to equity
    - Transferred to P&L on de-recognition
    - Negative FV goes to P&L
AAOIFI vs IFRS
Funding modes

Investment accounts

AAOIFI
► Quasi-equity
► Allocation of assets
► On or off balance sheet
► Sharing of profit and losses on declaration
► Disclosure implications
► Associated reserves may be created (PER and IRR)

IFRS
► Financial liability
► Carried at amortised cost
► Accrual of associated funding cost
AAOIFI vs IFRS
Financial statement presentation

- Statement of changes in restricted investment
- Statement of sources and distribution of Zakah
- Statement of sources and uses of Qard e Hasan
- Quasi equity concept
- Zakah expense separately shown
- Asset allocation in joint and self financing
- Difference in the definition of related parties
- Disclosure of earnings prohibited by Shari’ah
- Disclosure of social responsibility
- Role and activities of Shari’ah advisory board
Agenda

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Objectives of regulatory regime

- Credible banking proposition
- Effective regulatory oversight
- Customer protection
- Inclusion of Shari’a sensitive market segment
- Efficient mobilization of capital
- Compliance with international best practices

Stable Islamic Finance industry
Shari’a governance considerations

Islamic banks need to follow some Shari’a governance matters which are unique to Islamic financial institutions

- **Shari’a Supervisory Board**
  - To comprise of credible regional and local scholars
  - Establishes policies and practices and approves new products

- **Shari’a Compliance**
  - To monitor day to day compliance with Shari’a policies
  - Can be clubbed with the regulatory compliance function

- **Shari’a Audit**
  - Annual internal Shari’a audit is necessary to ensure Shari’a compliance
  - More central banks and regulators are considering making independent Shari’a audits a necessary requirement

- **MIS Framework**
  - Segregation of uses and sources of funds from conventional business
  - Profit management system
  - Profit Equalization Reserve, Investment Risk Reserve

- **AAOIFI Certification**
  - Leading standard-setting institution, universal acceptability
  - Helps mitigate local market limitations
Sharia governance considerations

Customers must remain convinced about credible Sharia systems

**MINIMUM BENCHMARK**

- Independent and Sharia sensitive Board of Directors
- Supportive and competent Management
- Independent Sharia Supervisory Board (minimum 3 scholars)
- Internal Sharia compliance / review and audit function
- Reliable MIS reporting system to track funds against asset pools
- Sharia training for all bank staff including senior management

**INDUSTRY BEST PRACTICE**

- Independent Sharia audit
- Sharia risk control function
- Sharia research capacity
- “Fit and proper” criteria for Sharia board members
- Formal training program for Sharia resources
- Formal periodic assessment of Sharia board members
- Central Sharia board for overall guidance and conflict resolution
Treatment of Investment Account Holders
A unique issue for Islamic banks with no perfect solution yet

- Equity of Investment Accounts Holders (EIAH)
- EIAH is on balance sheet
- Profit and loss sharing principle based on underlying contract (Mudaraba, Wakala)
- Deposit (as in Malaysia) or quasi equity (as in Bahrain)
- Capital adequacy implications
- Question of remuneration based on risks being undertaken
- Position on liquidation untested to date
- Risks carried are not reflected in governance practices
- **Weightage and pooling system** – how to ascertain fairness? Who is watching?
- Who is looking after the interests of EIAH? Shari’a board? Independent director?
Treatment of Investment Account Holders
Regulatory reforms to acknowledge the unique profit and risk sharing nature of Islamic finance

► Fundamental difference in the nature of depositors
► Capital advantage – IFSB Guidelines
► Capital adequacy – 10% Conventional vs 27% Islamic (illustration)

<table>
<thead>
<tr>
<th></th>
<th>Conventional Bank</th>
<th>Islamic Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk Weighted Assets</td>
<td>70% of assets</td>
<td>70% of assets funded by EIAH</td>
</tr>
</tbody>
</table>
Islamic banking and legal framework

Very often, legal frameworks of different countries need to be amended to provide Islamic banking with a level playing field

Key issues where exemptions may be required or the legal framework may need to be amended include:

► Real estate ownership
► Transfer / registration fee
► Ownership of and trading in assets / commodities
► Interest on deposit with Central Bank or other regulatory authorities
► Deposit insurance
► Tax on transfer or sale of real estate / assets
Liquidity management
A tricky issue for Islamic banks globally, with no perfect solution which fulfils both liquidity management and Shari’a legitimacy needs

- Organized Tawarruq, most commonly used for liquidity management, was declared Haram by the OIC Fiqh Academy in 2009
- Mudaraba or Musharaka contracts may also be used for inter-bank dealings
- Issuance of tradable Sukuk of various tenors by the central bank and/or other regulatory authorities is a possible alternative
- Foreign exchange transactions can be performed on the basis of Wa’ad (unilateral promise), whereby the counterparty promises to sell/purchase the foreign currency at a future date. The bank has the option to transact at the date of delivery or cancel the transaction. This should only be done for hedging the bank’s genuine foreign currency risk, not for speculation
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Double compliant proposition
Compete on product and service differentiation (Shari’a compliance embedded within banking business)

- Core Islamic – inclusive financial system
- Mainstream – Shari’a as a differentiator
Foreign investment from Arab Gulf

Leading international institutions and jurisdictions are positioning for the Islamic finance opportunity

- Goldman Sachs issues a $2bn sukuk program (2011)
- BNP Paribas launches sukuk fund
- Sub Saharan Africa allows Islamic banking
- HSBC Amanah Europe Equity Fund launched
- Deutsche Bank predicts Islamic finance boom … 15 Nov 2011
- Lloyds TSB rolls out Islamic banking across 2000 branches in UK…
- Nigeria to introduce Islamic banking regulations
- Credit Suisse – “demand for Sharia compliant assets to triple by 2016”
Lead the Africa Islamic Banking Initiative (AIBI)

More African countries are introducing Islamic banking – need for a regional Champion to provide leadership
**Way forward**

There is once in a century opportunity to position South Africa as a regional Islamic finance hub – key initiatives to include:

1. Awareness campaign
2. Core talent pool
3. Regulatory reforms
4. Connectivity with regional central banks and regulators
5. Connectivity with global Islamic standard setting bodies
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Thank You
“INTRODUCING SHARI’AH BOARDS AND THEIR ROLE FUNCTION”

PRESENTATION BY : MUFTI ZUBAIR BAYAT
REOWNED SHARI’AH SCHOLAR
Agenda

1. Shari’ah Scholar
2. Shari’ah Boards
3. Role of the Shari’ah Board
4. Challenges facing Shari’ah Scholars and Boards
Shari’ah Scholar

- Definition and required qualification
- Experience and exposure
- Shari’ah research capacity and problem-solving ability
Shari’ah Boards

- To comprise of recognised Shari’ah Scholars (minimum of three)
- Independence and integrity of Shari’ah Supervisory Board members
- Criteria for Shari’ah Board members
Role of the Shari’ah Board
Ensuring that the institute follows Islamic Principles and Shari’ah Standards set by a recognised Shari’ah Council such as AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institution)

Scope of work

- Establish policies and approves new products
- Hold regular meetings
- Review products and ensures strict compliance with Shari’ah standards before signing of certificate
- Oversee annual internal Shari’ah audit to ensure Shari’ah compliance
Challenges facing Shari’ah Scholars and Boards

- Shortage of Scholars and trained personnel
- Consistent Shari’ah standards
- Regulatory complexities
“CHALLENGES AND EXPERIENCES”

PRESENTATION BY : SHABIR CHOHAN
CHIEF EXECUTIVE, AL BARAKA BANK
Agenda

1. Introduction
2. Islamic Banking in South Africa
3. Size of the Islamic Banking Industry in South Africa
4. Key Differences between Islamic & Conventional Banking
5. Key Challenges & Experiences
6. Conclusion
Introduction

• Globally Islamic banking has made a considerable impact on financial services market

• Islamic finance is now globally integrated

• It has a presence in more than 75 countries worldwide

• About 63 % of Islamic finance institutions are in the Middle East, commanding more than 50 % of Islamic banking assets

• Approximately 38 Islamic financial institutions operate in Africa

• The industry is estimated to grow at a rate of 15 % - 20 % per year

• Global assets are expected to rise 33 % from 2010 levels ($826 billion) to $1.1 trillion by the end of 2012 (Ernst & Young)
## Islamic Banking in South Africa

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>First Islamic Bank licensed</td>
</tr>
<tr>
<td>1990</td>
<td>Second Islamic Bank licensed</td>
</tr>
<tr>
<td>1997</td>
<td>Failure of an Islamic Bank&lt;br&gt;• Industry uncertainty&lt;br&gt;• Low client confidence&lt;br&gt;• Slow industry growth</td>
</tr>
<tr>
<td>1997 – 2005</td>
<td>Only one Islamic Bank. Captive market, however pedestrian growth</td>
</tr>
<tr>
<td>2005</td>
<td>Emergence of Islamic windows (banks offering conventional &amp; Islamic banking)&lt;br&gt;• Confidence restored&lt;br&gt;• Greater market penetration&lt;br&gt;• Industry growth accelerates</td>
</tr>
<tr>
<td>2008</td>
<td>Financial crisis&lt;br&gt;• Economic downturn&lt;br&gt;• Islamic banking continues to grow</td>
</tr>
</tbody>
</table>

- **South African market very small, however potential for growth in Africa**
- **Estimate only 10% to 20% of Muslim community in South Africa invests in Islamic assets**
Size of Domestic Islamic Finance Industry
(R’ Billion) 2011

Relative Size of Islamic Banking Industry in South Africa
Size of Domestic Islamic Finance Industry (R’ Billion) 2011

Relative Size of Unit Trusts in South Africa

- Total Unit Trust Industry Assets
- Estimated Islamic Unit Trust Assets
Basic Model of Islamic Banking

- **Deposits** (No. upfront commitment on return on deposits)
- **Islamic Bank** (Investment pool)
- **Islamic Modes of Finance**
- **Clients** (Finance tangible or leasing assets)
- **Profits** (Distributed in Predetermined ratio)
- **Shareholders’ Funds**
Fundamental Differences:
Islamic Banks vs Conventional Banks

- No overdrafts
- No credit cards
- No predetermined profits on deposits etc.
- Only asset based, buy & sell, equity finance
- Maximum transparency

Ethical Finance
- Prohibitions:
  - Interest
  - Uncertainty
  - Short selling
  - Unlawful products & services

Key Strategy
- Promote greater ethical banking
- Social justice through risk & profit sharing

Operational Procedures
- Shariah Board
- Shariah Department
- Internal Supervision
- Shariah Audits

Sharjah

Structure of Products

SHARIAH

Ethical Finance

Structural

Industry Challenges

- Business challenges
Industry Challenges

Business Challenges

• The lack of scale
  - Scale is vital to driving down cost to income ratios

• Lags in finance profit rate adjustment

• Lack of adequate liquidity & risk management instruments
  - No liquidity secondary market for Islamic income instruments

• Takaful (Islamic insurance) – not well developed

• Impermissible income - non Shariah compliant transactions

• Fee income & investment limitations

• Human resources
Industry Challenges

Business Challenges . . . continued

• Issuing of guarantees
  - Interest factor

• Limited number of products

• Human resources
  - Shortage of Shariah scholars with finance expertise to drive the industry to the next stage

• Less profitable
  - Shariah management costs, business restrictions & income unrecognised
Summary

- Interesting time for Islamic banking in South Africa
- South Africa Government intends to establish the country as the leader in Islamic Banking on the African Continent
- National Treasury – evaluating proposals to issue sukuks (Islamic bonds)
- More conventional banks providing Shariah compliant products
- Public having greater choice in investing in Shariah compliant products
- Alternative to conventional banking
THANK YOU