Master's Thesis

Bujar Maraj's Master's Thesis On The Microfoundation of Islamic Capital Market Products

Chair of Economic Theory
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Abstract

Islamic banking is known for the prohibition of interest. The aim of this thesis is to investigate whether Islamic finance is substantially different from conventional practices. To this purpose, the paper analyzes several sukuk contracts, and concentrates on the features of Islamic finance. The analysis reveals that most products fail to implement key features and are economically rather similar to conventional debt. The paper also addresses the current situation of Islamic banking in Switzerland and its future prospects. At the moment, the engagement of Swiss banks in Islamic banking is limited. Some reasons for this are the lack of know-how as well as the preference of investors to direct their funds to Islamic countries rather than Switzerland.

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List of Abbreviations

AAOIFI	The Accounting and Auditing Organization for Islamic Financial Institutions
ADIB	Abu Dhabi Islamic Bank
DJII	Dow Jones Islamic Index
HNWI	High-Net-Worth-Individuals
FINMA	Eidgenössische Finanzmarktaufsicht (in english: The Swiss financial market supervision)
LIBOR	London Interbank Offered Rate
NIG	National Industries Group Holding Company S.A.K.
SPM	Special Purpose Mudaraba
UAE	United Arab Emirates
YTM	Yield to Maturity

Glossary[1]

Bay' Sale

Darura Necessity

Fatwa Legal opinion of a Shari'ah Board

Gharar Unnecessary risk

Hadith Reports of the words and deeds of Prophet Muhammad

Halal Allowed or permitted

Ijarah Operating lease contract

Ijara-Wa-Iktina Finance lease contract

Ijma Consensus

Ijtihad Independent reasoning of a group of experts

Istisna Partnership in manufacturing. The asset is bought or sold, before it comes to existence (e.g. a bridge)

Mudarabah A profit and loss sharing contract, between two parties. One acts as capital provider and the other one acts as entrepreneur. The capital provider does not have a say on investments, after investment has been done

Mudarib Agent with expertise or an entrepreneur

Musharaka A profit and loss sharing contract, between two parties. One acts as capital provider and the other one acts as entrepreneur. The difference between a mudarabah contract is that the investor has a say in investments, after the money has been invested

[1] The spelling differs from literature to literature. This glossary is according to Esposito (2013)

Murabaha A mark up contract in which a bank purchases a good on behalf of the client and later resells it to the client with a mark up

Qiyas Analogy

Qur'an Literally "recitation". The word of God

Ray Independent reasoning of one expert

Riba Interest

Salam or Bay' al-Salam Purchase with deferred delivery

Shari'ah Islamic law

Sira Prophet Muhammads biographies

Sukuk Certificate

Sunnah Habit, way or usual practice of Prophet Muhammad

Ujrah Rent, wage (depending on context)

Plagiatserklärung

Ich bezeuge mit meiner Unterschrift, dass meine Angaben über die bei der Abfassung meiner Arbeit benutzten Hilfsmittel sowie über die mir zuteil gewordene Hilfe in jeder Hinsicht der Wahrheit entsprechen und vollständig sind.
Ich habe das Merkblatt zu Plagiat und Betrug vom 22. Februar 2011 gelesen und bin mir der Konsequenzen eines solchen Handelns bewusst.

1 Introduction

The latest financial crisis has spurred increasing complaints regarding the current financial system. Proposals for reform of the traditional banking system along similar circumstances have been made in the past in the USA. These circumstances were alike to our current financial situation. One of the most adamantine supporters for reform of the financial system was Simons (1948). Simons claimed that the fractional-reserve banking system was "inherently unstable"; and this instability led to the bank collapse in the 1930s. His idea was to separate the bank into two different institutions, one of which would be in charge of payments, which only accepts deposits and maintains 100% reserves, to always be able to repay the savings. The second institution should work as an investment trust which can only invest the amounts of funds they receive. By splitting banks into two institutions the system would become more stable, Simons claimed. In fact this idea is not completely new, since the *Qur'an* proposes a similar system, but it goes even further. There is a ban on *Riba*. Riba stands for an addition to the principal, or more concrete, for a payment for the use of money which has been fixed beforehand, like interest. Riba is a form of excess, of unjustified enrichment and it therefore contradicts the teaching of the Qur'an. Economists have long recognized interest rates as one factor that determines savings in the economy, it is also an instrument to influence the economy. So how should an economy work without interest? In 1963 the first Islamic bank pioneered by Dr. Ahmed Elnaggar in Mit Ghamr (Mit Ghamr savings bank) in Egypt. It is not only the fact that Islamic banks do not charge or pay interest to their customers which distinguishes it from conventional banking, Islamic banking also does not violate the prescriptions of the Qur'an. Specifically, the Qur'an stipulates profit-loss-risk sharing arrangements, the purchase and resale of goods and services and the provision of services for a fee. The second important feature of Islamic banks is that they are in general prohibited from trading in financial risk products, such as options.

Several problems arise with the prohibition of interest. As Banks also have to act as merchants, their capital is bound to goods, which leads to illiquidity. In conventional banking practices this problem is easily solved, since banks can liquidate these assets by securitization. Also financing of governments under Islamic finance is more complicated than in non-islam banking systems. The answer to the problem of financing governments is *sukuk*.

> Sukuk and conventional bond securities have some similarities that led to practitioners and the mass media as well as some academics to consider sukuk as being similar to conventional bonds except for Islamic regulations applying for the issue of sukuk bonds. However, there exist some fundamental differences between the two instruments that such a description is misleading (see Ariff and Safari (2012)).

Sukuk securities are a good example, that Islamic finance does indeed provide the basic blocks that can be used to construct more complex instruments that will enhance the performance of these institutions. Some critics contend that Islamic capital market products are more or less the same as conventional products, and they collect interest in one way or the other.

The aim of this thesis is to investigate whether Islamic finance is different from the conventional practices. The focus lies on the analysis and discussion of Islamic capital market products (Sukuk and derivatives) with respect to their basic structure and incentives, such as how they solve incentive problems. Financial engineering can be viewed as repackaging different components of existing instruments with respect to return, price, risk etc. Therefore this thesis will also give a broad understanding of these basic building blocks, to enhance the understanding of the more complex capital market products. Furthermore it will analyze what kind of products exist in Switzerland and how they are promoted by interviewing practitioners.

Therefore this thesis will be structured as follows. The next subsection will give a brief review of the literature on Islamic Banking so far. Section 2 deals with principles of Islamic law and highlights the differences between interest and trading. This section will also provide information about the major financing instruments in Islamic banking. Section 3 covers the financial markets and explains how different sukuk are structured. Section 4 investigates in real world sukuk which were traded in the market. It highlights the main issues with these products. The last two sections 4.3.1 and 5 will contain an overview of Islamic banking in Switzerland and the final discussion of this thesis.

1.1 Literature Review

Capital markets are key for savers (investors) and entrepreneurs, since they help allocate capital to projects where it is most needed and used most efficiently (see Wurgler (2000)).This holds only if the market correctly rewards the participants by appreciation or depreciation of their stocks. Liquidity and correct pricing of risk encourages more and more savers to invest their money in capital markets, furthermore it makes capital markets more trustworthy which also raises the acceptance of the banking system as a whole in a country. This means in turn that the development of an Islamic banking system is not separate from the development of a functioning capital market(see Ali (2005)). The primary market directly influences the availability of funds, whereas the secondary market affects the pricing and liquidity of the assets and therefore indirectly influences the availability of funds. In short, capital markets are key for the development of a functioning and broadly accepted Islamic banking system. In the early stage of the development economic growth relied on domestic funding sources, nowadays growth is additionally boosted by capital funds from abroad (see Ali (2005)). This highlights the importance of international acceptance of Islamic capital markets if the Islamic financial system aims to reach a significant economic importance. Ali (2005) focuses on the state of equity and sukuk products in Islamic capital markets, in which he took Bahrain, Malaysia, Pakistan and Sudan as samples. He finds that Shari'ah compliant stocks in total market capitalization varies a lot between countries. Many of these markets are not growing enough to achieve a critical mass and those that are do not contribute enough for the economic development and distribution of wealth. Some companies are not seeking listing at their domestic stock exchange which is an indication of lack of confidence. Sukuk are another class of capital market products. Their growth was fast and they are still expected to grow. Unfortunately a secondary market for sukuk does not really exist, which hinders the overall growth of these institutions. Sukuk are considered in the western world as being similar to conventional bonds. Safari (2011) looked at yield to maturities (YTM) of ijarah sukuk and conventional bonds from 2005-2011. He found out that YTM for conventional bonds and sukuk are significantly different controlling for the issuer and issue tenure. He also studied the causal effects which one product may have on the other. "Granger causality tests do not show a general and definite relation between yield of Islamic sukuk securites and conventional bonds" (see Safari (2011) p.18). In other words, there is no causal effect. The last interesting point which they found out is that even if general opinions are that sukuk are priced like bonds, they are probably not. Issuing ijarah sukuk leads to a significant change in the risk pattern of the issuing company[2]. The risk is documented in absolute change in beta before and after issuance of the sukuk. However, there is no clue in which direction beta changes, because it does not change in the same way across companies. Even if conventional banks are flushed with capital since 2007, Standard and Poors (2013) believes that the sukuk market will continue to grow, mainly because of the low rates paid in the conventional system. The overall economic growth in Malaysia, Saudi Arabia, Qatar and the UAE will further support sukuk issuance. Yields on sukuk have fallen below yields on conventional bonds, this is caused by strong preferences for bond markets over the struggling equity market. The lower yield on sukuk is an indicator for an increase in sukuk issuance, claims Standard and Poors. Liquidity of sukuk has only grown slowly, but as more and more investors seek for sukuk which are listed and not over the counter traded, this issue will improve with time. Iqbal (1999) claims that "presently, Islamic financial markets are deficient in

[2] Assets have to be taken out of the balance sheet, this happens when a company creates ijar'ah sukuk. The creation of ijar'ah sukuk is explained in section 3.3.1

both liquidity and risk management tools". The market is dominated by short-term trade (mudarabaha) and sales (ijar'ah) products. Iqbal further says that the reason why Islamic finance still lacks risk management tools is due to the lack of research in this area. Islamic finance is still a new area which urgently needs more research.

2 Principles of Islamic Finance

This section deals with the principles of Islamic finance.The term *Shari'ah* is always used in the context of Islamic finance. The Shari'ah Board has to confirm the compatibility of every financial product before a bank is able to release it. There are basic methods that the Shari'ah Board uses to confirm a product, which will be explained in section 2.2. More complex instruments are a combination of the basic finance contracts of Islamic finance and modern financial markets theory, thus to understand the capital market products one has first to understand the underlying principles. This section is based on the literature of Iqbal and Mirakhor (2011), Kahf and Khan (1992), and Altundag et al. (2003).

2.1 Rise of Islamic Finance Institutions

Since the inception of Islamic finance in 1963 it has grown quite rapidly. Today these institutions are concentrated in the Middle East and in Southeast Asia, especially in Bahrain and Malaysia as core hubs, but they also appear in European countries and the USA (their presence extends to 75 countries). Islamic finance presents itself as an alternative to conventional finance, not only to Muslims but to non-Muslims as well, especially in such unstable times. In time, hundreds of Islamic financial institutions have evolved. Total assets worldwide are estimated to exceed \$1.3 trillion by now and they are forecast to grow beyond the \$2trillion mark by 2014. "The Islamic banking growth story continues to be positive, growing 50% faster than the overall banking sector" (Ernst and Young (2013)). However, exact figures are difficult to find. Nonetheless

Islamic banking is the fastest growing branch in the banking industry. Its penetration in every society where Islamic banking is present is growing (Dar and Azami (2011)). These figures may look impressive but they should be seen in proportion to the global financial industry[3]. Many of the Muslim intelligentsia members, most of them in the gulf region, believe that modern globalization is driven by materialism. These characteristics are incompatible with the values cherished by Muslims (Najjar (2005)). Thus, Islamic finance can also be seen as a movement of Muslims to retain their own identity (Kuran (1996)). Another important motivation for developing an economy based on Islamic principles was the conviction by European civilization that Islam is backward. The idea of Islamic economics[4] was first formed by Maulana Sayyid Abu'l-A'la Maududi in 1941. It took some time to develop the idea of what an Islamic economy should look like. At the beginning it was a process of trial and error. The development really took off when the government of the country (in this case it is the government of Pakistan) started to promote Islamic economy. The first step was to ease into Islamic finance by adapting the regulatory system to its new circumstances. There are several other reasons behind the recent growth in Islamic finance: First, there is a strong demand from the Muslim community around the world for Shari'ah compliant financial services. Second, the growing Malaysian economy with its successful implementation of Islamic banks in its country and the rise in oil wealth in some Muslim regions during the oil crisis in 1973-74. Third, the products provided by Islamic Institutions attract Muslim and non-Muslim investors. The enormous wealth in these countries also motivated western governments, banks and companies to provide Shari'ah compliant products, like Sukuk to attract these financial sources.

[3]See the financial report 2012 of UBS with total assets of $1.3 trillion

[4]Islamic finance can be seen as a part of Islamic economics

2.2 Principles of Law

Islam legislation is different from the western legislation. Islamic financial products need to be Shari'ah conform, but since there were no complex financial products available at the beginning of Islam, there is no precise guide as to how to deal with modern financial issues. Rules for Muslims springs from various sources. The first and most important is the Qur'an itself. Muslims believe that the Qur'an is the word of God, which was revealed to the Prophet Muhammad, by the angel Gabriel (Visser (2009)). The second important source is the *Sunnah*.

Sunnah means "habit", "way", or "usual practice". It refers to the utterances, actions and examples of Prophet Muhammad that should be followed by Muslims. The Sunnah in turn consists of the *Sira* and *Hadith*.

Sira is the Arabic term used for Prophet Muhammads biographies. For Islamic law and doctrines even insignificant actions of Muhammad are important.

Hadith Basically it is a collection of narrations about certain incidents in which Muhammad said or did something.

The Sira and Hadith collectively form the Sunnah (see Esposito (2013)). In fact the Sunnah is a law of behaviour, not just as the laws of natural objects, but a normative moral law (see Rahman (1962)). Together the Qur'an and the Sunnah form the Shari'ah. The Hadith contains informations about how to act in the "sale of a golden necklace" or "the selling of a camel", but there is little information about corporate government, public utilities or intellectual property, not to mention complex financial products (see Visser (2009) p. 11). Thus, since not everything is strictly regulated, Islamic legislation also has to take secondary sources of law into account. There are two secondary sources available such as *Ijma* (consensus), and *Qiyas* (analogy)[5].

[5]Now depending on the scholars, there are even more secondary sources, which

Ijma is the Arabic term of consensus, therefore it is a rational proof of law. It is considered to be the third proof after the Qur'an and the Sunnah. This means if a community agrees on a specific law, it has to be applied. The problem behind this is that there is no consensus about the definition of consensus, therefore it is not a guarantee for a solution (see *Ijma (Consensus of Opinion)* (2013)).

Qiyas means analogy. It is the fourth "root" of Islamic law[6]. Issues which are not explicitly covered by the Qur'an or the Sunnah can be answered, provided that the new problem is somehow related to an issue described in the Qur'an or Sunnah. The same effective cause has to be given, otherwise qiyas cannot be applied(see Esposito (2013)). As mentioned above, according to which scholars you refer to, there are even more secondary sources of law. Many scholars include also *Ijtihad* and *Ray*.

Ijtihad "is the independent reasoning by a qualified jurist leading to new legal rules" (see Visser (2009) p.12).

Ray is a method formally used in conquered territories by the Muslims. It is an expert view on legal issues, but the critical point is, that these experts could make the rules by personal reasoning. This method was abolished shortly after the inception of Islam.

If ijma, qiyas, ijtihad are not sufficient to find a solution, jurists may base their ruling on further methods, which will not be covered by this thesis[7]. However, there is no common view on the authority of the various sources. Thus, the disagreements on how to create a rule and find out what is right or wrong makes it even more delicate for Islamic finance to deal with its issues. Therefore, it is no surprise that some financial

they can rely on

[6]According to al-Shafii the founder of the Shafii School of Law, there are four "roots": Qur'an, Sunnah, Ijma, Qiyas

[7]For further information about this topic see Visser (2009) p. 13-15

products are allowed in one country and prohibited in another one. In summary, these methods should be consistent with rational thinking and should take the public interest into account.

2.3 Key Principles of Islamic Banking

While conventional banking is primarily based on financial aspects, according to Islamic banking Scholars, Islamic banks treat moral, ethical, social and religious aspects in the same way as financial ones.

> The central goal of Islam is to develop an egalitarian social structure in which all men and women can maximize their intellectual capacity, preserve and promote their health, and actively contribute to the economic and social development of society. Economic development and growth, along with social justice, are the essential elements of an Islamic economic system. People of all genders, ethnicities , and religious creeds are considered equal in an Islamic society because all humans are required by God to partake in the formation of an educated, economically secure, and ethical society (see Askari et al. (2010) p.48).

Probably the most prominent characteristic of Islamic finance is its prohibition of riba (interest). Beside riba there are some more principles which will be highlighted on the following pages.

- Creating money out of money is prohibited

  The underlying axiom behind this rationale is that money is only a means of exchange, nothing else. There are several reasons for this axiom.

  - The ***only*** use of money is to buy a good or a service.
  - In general the price of a good depends on its quality, but, as opposed to a good, you cannot compare the quality of money.

A slightly ripped 10 CHF note is worth the same as a smooth 10 CHF note.

- Rationale behind Riba

  Neither the Qur'an, nor the Sunnah provide a precise reasoning for the prohibition of riba. The most frequently articulated reason for the prohibition of interest is that it is seen as unfair. Interest favors the exploitation of the borrower or the lender, which violates core elements of the Islamic teaching of social justice:

  - In an interest-bearing transaction the lender is guaranteed a payment on top of the principal amount, no matter how the business of the borrower develops. In most cases the borrower has to cover the debt with collateral, which inevitably transfers all the risk to the borrower.
  - In contrast to that, the borrower's business may prosper very well. The lender is guaranteed a fixed interest, but the borrower is earning maybe 20 times the interest rate. This is also seen as unfair[8].

  Those who spend their time, capacity, resources and efforts to run a business have no guaranteed profit at any fixed rate, therefore those who lend money and are secured against loss shall neither receive a guaranteed rate of return. Nor shall any entrepreneur enrich himself by running up debts in a smart way.
  The motives for lending in Islam are different from conventional banking. The reasoning behind conventional banking to give a loan is to earn interest, the reasons behind Islamic teachings are the following:

  - Provision of help. "In the early Islamic society financing was provided through the motives of help (lending) and the expectation of profit: Although lending serves the financial purpose of the borrower, it is not dependent on market factors" (Kahf and Khan (1992) p.18).

[8] For a different perspective why interest harms the economy see Kennedy (1991)

- Safekeeping purposes.
- Profit and loss sharing. The lender has the opportunity to lend his money to a business, with the prospects of profits, but he also has to bear any losses if they arise.

The adoption of interest by the Shari'ah would create an environment where few people would lend money for help. This makes profit maximization as the only goal of banking activities, which in turn leads Islamic banks to converge to the lending model of conventional banks[9].

- Risk Sharing

  Pure debt security is not allowed in Islamic finance, therefore to invest in a company you have to become an equity investor. Islamic finance postulates profit and loss sharing as the best solution. The idea is that through entering a partnership both are pushed to optimal activities for a successful development of the undertaking[10]. The "debtor" receives help for his business idea and the "creditor" earns higher returns in comparison to an interest based lending. In case of unfavorable developments both partners bear the loss, therefore the risk is shared.

- *Gharar*

  The term Gharar means exposing oneself to unnecessary danger where you have too little information or asymmetric information about key factors of the transaction. Therefore, games of chance or lotteries are not allowed. But Gharar is not limited to games of chance, it also influences financial markets. This makes it hard to develop financial market instruments, such as Options or Futures for Islamic banking, because the price of an asset should be known in advance and purchase with deferred delivery is also prohibited. In addition to that, Islamic finance also discourages hoarding of money.

[9] This inevitably makes Islamic banks to converge to conventional banks, since there is otherwise no fundamental difference

[10] However, this works only if both are honest individuals, as game theory tells us

- *Halal* activities

  Halal means "allowed" or "permitted". It identifies all activities which are permitted by the Shari'ah. In contrast to that, *Haram* identifies taboo things. Investments should only support Halal activities. Here are some examples for *Haram* products:

  - The purchase of shares in banks which do interest-based business.
  - Investments in companies which produce alcohol or tobacco.
  - Investments in pig meat processing companies
  - All kind of gamble of chance or equivalent activities
  - Investments in night clubs, or activities which are associated with pornography or prostitutes.

- Asset-based

  There is a "existence" aspect in Islamic finance that links financing with its underlying asset. This ensures that the financing activity is clearly and closely linked to the real sector activity. Money is seen as "potential" capital, because it can not grow on its own, it has to be invested in the production activity first. At the time of investment, money becomes capital (e.g. physical capital) and is able to grow. This ensures a strong link between the return on money used to finance and the return on the real asset (see Iqbal and Mirakhor (2011) p.10). By forcing this link, there is less space for bubbles, which can harm the economy.

- Compliance to contracts and property rights

  "Islam upholds contractual obligations and the disclosure of information as a sacred duty" (see Iqbal and Mirakhor (2011) p.11). By doing so, Islam reduces asymmetric information and moral hazard. The preservation of property rights is also key to the Islamic teachings, therefore it prohibits the breach of anyone's property rights.

2.3.1 Basic axioms for the justification of Profit, Rent, Wage and prohibition of Interest

Profit, rent, wage and interest are considered to be factors of production in conventional economics. The only factor which is uncertain is profit, since the others are fixed (at least in the short run). "Rent and wage are treated as one and the same, as the term *ujrah* is used for the price of both human resources per unit of time (wage) as well as the usufruct rights of fixed assets (rent)" (see Kahf and Khan (1992)). Now the question arises what is seen as profit in Islamic finance and why is it different from ujrah (rent/wage) and interest? Profit may arise from changes in conditions, such as changes in supply and demand. It can be a result of natural growth processes such as growing crop on land. Profit is not directly linked with someone's effort or spendings. But it can of course arise out of the efforts and the risk taking of someone, too, such as in the development of a new product. In Islamic economics there are two ways in which physical capital and labor may enter a production process. One is ujrah, the other is a profit sharing basis (see Iqbal and Mirakhor (2011)). The choice depends on preferences - whether decision making responsibilities are desired or not. If either of them disclaim uncertainty, they will limit their return to a predefined amount (ujrah) per unit of time. Money is just a mean of exchange and does not, in isolation, generate a service or cash flow. In the same manner, debts are personal obligations, they cannot grow independently. Money and debt can only grow in the process of exchange (e.g. invested in physical or human capital) by entering the production process. By doing so it is sharing the uncertainty and risk inherent in a market economy.

To summarize there are three main assumptions according to Kahf and Khan (1992) that justify return in Islamic economic thinking.

- Probably the most important axiom is the characteristic of an asset. The key characteristic of such an asset has to be that it cannot be depleted (e.g. a machine, land or a building). It is then allowed to be rented or to be given away on a profit sharing basis.

- Human resources are a special form of assets. Since this asset fulfills the characteristic of no depletion it can be given away on ujrah (wage/rent) or on profit sharing basis.

- The basis behind ujrah is that the resources are finite. Therefore they enter the market and become subject to the law of supply and demand. Ujrah earners are like profit earners subject to the inherent market risk. However, the main difference between these two types is the extent of risk taking.

2.3.2 Difference between sale and interest

It is crucial to understand the difference between *bay'* (sale) and riba (interest), as God permitted sale and prohibited interest, as stated in the Qur'an: "... they say that indeed an exchange transaction (bay') is like a riba (interest-based) transaction. But Allah has permitted exchange transactions and forbidden interest-based transactions" (see Asad (2011) (2:275)). The main distinction lies in the transfer of property rights which result in these two transactions. While property rights fully transfer in a sale contract - thus allowing both parties to share the transaction risk - there is no transfer of property rights in an interest-bearing transaction. A lender does not only retain property rights for the principal amount of money but the additional property rights over the interest is also transferred from the borrower to the lender on the date the riba contract becomes effective (see Iqbal and Mirakhor (2011) p.38). Therefore, there is no risk sharing at all in an interest-bearing transaction, since the lender also requires capital protection.

2.4 The Major Islamic Finance Products and its Characteristics

There is no standardized classification of contracts in Islamic finance. Thus, depending on the author, classification may be done according to their function and purpose in the economic and financial system or according to their characteristic, e.g. debt-like or equity-like financing. Hereinafter the major financial contracts will be explained. This subsection is based on the writings of following authors: Iqbal and Mirakhor (2011), Visser (2009), Hassan and Lewis (2007), and Kettell (2011)

2.4.1 Murabaha (cost-plus financing)

Although Islam postulates risk-sharing contracts, in most cases murabaha accounts for 70%-80% of total assets. In this contract the bank purchases the product for the client and in a second step the bank sells the product to the client. The bank and the client agree in advance on the profit margin or "mark-up" which is added to the cost of the product. It is crucial that a murabaha is the result of an original sale, therefore it should not be used to finance existing inventory. The financier also must take ownership and possession of the product to be valid under Shari'ah. Payments to the bank shall also be agreed in advance, it might be a lump sum or installments. Another distinct feature to conventional banking is that, in case of default the bank has no recourse to the item financed and no further claim on the mark-up. The mark-up rate charged by the bank is linked to the product, the type of security[11], the creditworthiness and the length of time for which financing takes place. It is important to note that the mark-up is also linked to the LIBOR. Now this creates misconceptions about the instrument, however researchers have adressed this point and come up with following explanations. It is pointed out that in an interest-based contract money is loaned, whereas in a murabaha a specific asset is bought. The more, a loan is exposed to credit-risk only. In contrast the bank in a murabaha contract is exposed to credit risk but also to price risk, when the product is acquired for the client. The client might refuse to accept the delivery, since he/she has an option to do so. The use of LIBOR has been widely criticized.

[11] The bank may ask for collateral, normally something else than the product bought

"Islamic banks often argue that the mark-up rate is the function of an interest rate index because there is no Islamic benchmark that can provide an indication of the prevailing rate of return in the economy" (see Iqbal and Mirakhor (2011) p.85).

2.4.2 Tawarruq

Tawarruq is an instrument which imitates a conventional loan. It is also known as "reverse *mudarabah*". It is a mechanism for borrowing cash where the tawarruq beneficiary undertakes two separate transactions including three different agents.

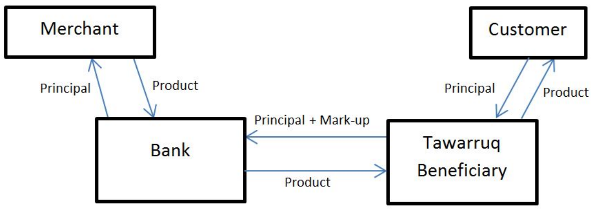


Figure 1: Sturucture of a tawarruq

A tawarruq transaction works as follows: a bank purchases a product for a client on a murabaha (cost-plus) basis. The customer in turn sells the product immediately to a third party for cash. Notice that the price for which the client sold the product is lower than what he has to give back to the bank. Hence, the client has turned his product into money. There is considerable resistance to tawarruq, since the transactions in combination form nothing else than a zero-coupon bond for the bank. However, if the contracts are analyzed in isolation, they are Shari'ah conform. Tawarruq is not widely accepted, in most cases Shari'ah Boards judge from case to case if its legitime or not (Gassner and Wackerbeck (2010) p.56). Tawarruq may be allowed on a *darura* (necessity) basis.

This necessity may be on the client's side:

- Transfer of conventional debt to an Islamic bank
- Payment for a medical treatment
- Marriage with a special religious ritual

On the other hand the bank may also be in urgent needs for tawarruq:

- In the absence of a solution for liquidity management
- After the transformation of a conventional bank into an Islamic bank. Because the bank may need more time to provide a complete supply of Shari'ah conform products.
- If an Islamic bank acts in a non-Muslim country

2.4.3 Mudarabah (trust-finance)

Mudarabah is a special case of partnership, therefore it is also called an intermediation instrument. An agent with capital comes together with another agent who has expertise in deploying capital. It is also called a trust finance, because the investor does not have control over the capital after the contract is signed. The *mudarib* (agent with expertise) allocates the money how he/she thinks it is best for the business. Like mutual funds in conventional banking systems. However, if the investor wishes to have some control they may impose upfront restrictions on the mudarib. This is called a "restrictive mudarabah". Financing is done 100% by the investor and profit distribution is based on a pre-agreed ratio. Any losses are solely borne by the investor, as long as the mudarib acted prudently and in good faith. If the loss occurs because of misconduct or negligence of the mudarib, then the mudarib has to bear not only the loss of time but also the capital loss. The distribution of profits in a mudarabah can only take place after the capital owner has received the capital back. Mudarabah covers in general short term facilities, like working capital.

2.4.4 Multiple Tier Mudarabah

A mudarib may also develop multiple partnerships on a mudarabah basis, to create a large pool of capital. This is common to create a mutual fund, either open-ended or closed.

2.4.5 Musharaka (partnership)

The Shari'ah promotes musharaka financing because it is the purest form of Islamic finance. It can be understood as a partnership of two or more people who combine capital with expertise to share the profit and losses. The partners enjoy equal rights in all aspects, if nothing else is agreed upon. Like in a corporation partners cannot be liable for more than their capital invested in the venture. The partnership agreement does not have to be written, it can also be informal and oral. Profits are shared on a pre-agreed ratio; no fixed amount can be determined and losses are absorbed in proportion to equity participation.

2.4.6 Ijarah (operationg lease)

This term refers to sale of the right to use an asset. The owner of an asset rents it for a specific period of time against fixed rental payments. The lessee has no option to purchase the asset at the end of the contract. Hence, the lessor can rent his/her asset several times. However, the lessor is also in charge of maintenance and insurance of the asset. All terms of the ijarah contract should be listed in detail, such as the purpose of use, duration of the lease, rental payments etc. The asset must not be consumable, because the contract is intended for the utilization of the asset, nothing else. The difference between ijarah and conventional lease agreements is that there is an absence of compound interest in the event of default or delay. Similarities to conventional lease contracts make ijarah attractive for Muslims and for non-Muslims. Ijarah contracts are also important for Islamic financial market products, since they were used in the launch of sukuk.

2.4.7 Ijara-Wa-Iktina (finance lease)

This is very similar to the basic ijarah contract but here the lessee has the option to purchase the asset at the end of the contract. The bank purchases buildings, equipment or an entire project for the purpose of renting to a client. The client in turn pays rental plus additional payments in an Islamic investment account which leads to the purchase of the asset from the lessor.

2.4.8 Istisna (partnership in manufacturing)

This contract is suitable to the construction industry for building infrastructure, housing, aircrafts, ships etc. The crucial point here is that the asset is bought or sold before it comes into existence. The contract requires the asset to be manufactured or constructed. In addition this instrument provides flexibility in payment of the project, since the client does not have to pay in advance nor at delivery, it is up to the agreement how the client is going to pay. So the bank funds the manufacturing/construction, takes possession of it and then sells it to a third party.

2.4.9 Salam or Bay' al-Salam (purchase with deferred delivery)

According to this contract, the buyer pays an agreed upon price in advance for the assets to be delivered at a future date. It is similar to a conventional forward contract, but they differ in terms of payment arrangements, since in a conventional forward contract the payable amount is due at the end. Remember in general there is a prohibition to forward sale. However, salam is an exception to this rule, because payment in advance allowed the farmers in Mohammads time to buy their facilities (seeds, raw materials etc.) and therefore to produce. Since this is an exception it comes with strict conditions:

- The quality and quantity can be fully specified in advance. For example, two pieces of a product must be the same in weight, size and quality
- Full payment is due at the date of signing, no later
- The delivery date has to be specified in advance
- The product sold has to be at least in constructive possession of the seller

3 Financial Markets

"The primary role of a financial system is to create incentives for an efficient allocation of financial and real resources for competing aims and objectives across time and space" (see Iqbal and Mirakhor (2011) p. 113). Efficient financial systems are expected to facilitate financial intermediation, through reduction of monitoring, information and allocation costs. Therefore a stable payment system must be given. In addition to that it is important to offer an efficient and liquid money market for risk trading. Given that information asymmetries and incentive problems exists, capital markets offer better contracting through the market.

3.1 Capital Markets

Conventional capital markets are dominated by the debt market, because it is considered the major source of external funding for governments and corporations (see Ali (2005)). However, there are two more categories in which the conventional capital markets can be divided, such as stock markets and markets for structured securities. The latter consist either of equity or debt, thus named hybrids. In contrast, future Islamic capital markets consist of two main categories; the stock market and the securitized "asset-linked"[12] securities. A debt market will not existent, because of the prohibition of riba.

3.1.1 Stock market

The conditions for a stock market to be consistent with the Shari'ah are similar to the ones in the markets for goods and services. The Shari'ah requires that all market participants act in accordance with the ethical and moral teaching which it provides. So that a proper underwriting is given by the banks. Even if stock exchanges are permissible in Islamic economics, not all instruments and practices on stock exchanges are in accordance with the Shari'ah. Speculation is prohibited, therefore it is not allowed to invest in a company for short term gains. All investments should be done to improve the situation of a company and therefore be long-term, non speculative and related to real economy (see Asutay (2007)). By contrast, modern economic literature defends speculation as a powerful instrument to identify better prices and keep the market liquid. The Dow Jones Islamic Index (DJII) has developed screening criteria that are widely accepted among Islamic jurists (see Tamer (2003) p. 109). DJII screens permissible stocks through the means of two knock out criteria. First, they check if companies engage in Halal (permissible) activities. Second, they screen financial ratios.

- Drop out companies, if $\frac{Total\ Debt}{12\text{−}months\ Average\ Market\ Capitalization} \geq 33\%$
- Drop out companies, if $\frac{Accounts\ Receivable}{Total\ Assets} \geq 45\%$
- Drop out companies, if $\frac{\sum_{i=1}^{n}(Cash_i + Interest\ Bearing\ Securities_i)}{12\text{−}months\ Average\ Market\ Capitalization} \geq 33\%$

"The Shari'ah Supervisory Boards of most Islamic fund managers and other equity indices have reached very similar compromises" (see Tamer (2003) p. 110). In general the factor "market capitalization" is substituted by "total assets". Sometimes there is also an aditional screening

[12] This term is suggested by Iqbal and Mirakhor (2011). The difference between "asset-backed" will be explained later in the text

criteria: companies with more than 5% interest income to total income are excluded.

However, the stock market provides an alternative source to fund the activities of companies, and as such they do not rely too much on banks. The market ensures an efficient allocation of resources, by providing relevant information to investors, just as it does in the conventional system. An active stock market allows for risk diversification for managers seeking to reduce their aggregate and idiosyncratic risk. Stock markets can not only be beneficiary for corporations, but also for governments. As interest is prohibited, governments also have to rely on other instruments than bonds.

Governments may finance their budget through the stock market, which would create the following positive externalities, suggested by Iqbal and Mirakhor (2011).

- Strengthening the credibility of the market, provided that all preconditions regarding regulatory, administrative and human capital framework are given
- Allowing the market to get deeper and broader
- Assisting large projects without the fear of an undue burden on the budget
- Stopping further inflationary effects by limiting the amount of money creation
- Creating better governance and more efficiency in government owned companies

The creation of such instruments issued by governments is not difficult, as we will see later.

3.1.2 Securitized markets

Since the financial crisis of 2008, the securitization technique of conventional financial systems has faced much criticism. In contrast, Islamic finance promotes a strong link between money and the underlying real asset. These asset-linked securities will form the second pillar of Islamic capital markets. Securitization works as follows: For example, the government pools several homogenous assets with a known cash flow stream. These assets may be financed by an ijarah (operating lease) or istisna (partnership in manufacturing) contract. The assets serve as collateral to the investor if the market declines. Using the underlying assets as collateral and making the investors the direct beneficiary of cash flows, assures the direct link to the securities risk/return profile. This direct link of risk/return distinguishes the Islamic form of securitization from the conventional form, where securitization is referred to "asset-backed" security. Asset-backed securities are in most cases exposed to the credit risk of a guarantor (the issuer of such instruments) and to the risk of the underlyings returns. This fact eliminates a direct link to the risk/return profile of the underlying asset.

Note, that if such an asset-linked product is structured on a istisna or ijarah contract it would permit the differentiation of securities in terms of maturity. In addition, the predetermined cash flows with their low credit risk make it a good substitute for fixed income securities.

Securitization enables banks to free up their invested funds and therefore to strengthen their liquidity basis. These marketable securities can be designed according to the risk appetite of investors and bought and sold on an exchange in the primary or secondary market.

	Conventional asset-backed security	Islamic asset-linked security (Theoretical—not current practice)
Security type	Fixed income (debt-based)	Hybrid depending on the contract and underlying assets. Could be quasi fixed income or risk sharing or both
Ownership	Security holder does not own the asset but owns a security against the asset	Security holder has ownership interest in the underlying asset
Recourse	Security holder does not have recourse to the asset in the event of distress	Security holder has recourse to the underlying asset in the event of distress
Pricing variables	Based on expected yields, current interest rates, and other variables influencing the asset owner's decision-making to prepay or refinance. Creditworthiness of asset owner or the guarantor influences prices	Based on expected yields, current levels of returns, market value of underlying assets, and expected value of the underlying asset at maturity
Linkage with asset value	No direct link to the market value of the underlying. Indirect variables such as loan-to-value (LTV) ratio are used as proxy.	In general, final or other payoffs may be linked to market value of the underlying asset.
Principal protection	Principal is protected irrespective of the value of underlying assets	Principal is linked to market value of underlying
Risk shifting	Risk transfer	Risk sharing

Figure 2: Comparison of conventional and Islamic securitized securities [13]

Figure 2 presents a comparison of conventional and Islamic securitized securities. The former is a debt instrument, which is undermined by the ownership structure and the pricing variables, such as current interest rates and credit-worthiness. There is no direct link to the asset and the security transfers the risk from the issuer to the investors. The latter is dependent on the underlying contracts and assets to define if it is a fixed or equity-like instrument. Pricing is based on expected yields, current levels of return, market value of the asset and expected market value at maturity. The security holder is the actual owner of the underlying asset, since recourse is given in case of distress. The security also provides a risk sharing aspect as proposed by the Shari'ah.

Given that the debt market, as known in the conventional financial system, is prohibited, Islamic financial capital markets have to be extended

[13] Source: Iqbal and Mirakhor (2011) p.127

with an asset linked securities market. Whereas stock markets have a higher volatility in general, asset linked securities can provide a wide range of risk/return profiles and thus vast diversification benefits. See figure 3 for an extended comparison of stock market and asset-linked securities.

	Stock-market security	Asset-linked security
Risk	Business risk	Asset risk Credit risk
Collateral	Business assets (tangible and intangible) Equity capital	Underlying assets
Returns	Depends on business growth and earnings; residual claim on assets	Depends on cash flows of underlying assets
Cash flows	Less predictable	Deterministic
Volatility	Medium to high, subject to sector or business volatility	Mostly low but could be medium to high depending on the nature of securitization and degree of risk sharing
Contractual agreement	Equity share Capital ownership	Diverse, ranging from leases (rental) to equity (risk-sharing). Could be amortizing or rental stream or pass-through
Recourse	None. Last claim on residual assets	Ownership of underlying assets
Pricing	Based on the expected growth and the earnings of the business	Creditworthiness of asset holder and the market value of underlying asset

Figure 3: Comparison of stocks and asset-linked securities [14]

3.1.3 Derivative Markets

The third point which needs to be mentioned is the derivatives market. These instruments are a phenomenon of modern financial systems, therefore there are no precedents in Islamic jurisprudence. These markets have three main functions.

- To transfer risk and facilitate the redistribution of risks
- To increase information flows and therefore enhance price discovery and stability

[14]Source: Iqbal and Mirakhor (2011) p.128

- To customize payoffs and monetize them

Islamic finance securities must be linked to the real economy and must thus have an underlying asset which is subject to sale and purchase. An option is just a "right" to buy or sell something, but a "right" is no asset, and therefore it is at the utmost a contract. Remember one of the basic principles which says "creating money out of money is prohibited". Money can be seen as a standardized contract, which allows you to buy something you want. Therefore trading derivatives, such as options, would be like trading with money. In addition, derivative markets are subject to high speculation and this is prohibited (gharar). However, even if these markets can lead to better price discovery and more efficiency, it is a very delicate issue, which has just started being discussed among Islamic Scholars.

3.2 Sukuk

Sukuk (pl. Sak) is the Arabic word for certificate. It is one of the most interesting fields in Islamic Finance at present. The market for sukuk is growing rapidly, because it covers the needs of many issuers and investors seeking for bond-like Shari'ah conform products. Because of the prohibition of riba many investors urgently need a way to fill the gap for fixed-income products. On the other side there are also many issuers who are looking to pay fixed amounts of money to have more predictable outflows. The solution for this problem is sukuk. Even if in most papers sukuk is used as a synonym for Islamic bonds, it is important to keep in mind that these two products are fundamentally different. Sukuk reflects participation rights in the underlying asset. A bond in turn creates a lender-borrower relationship and it is pure debt finance, whereas a sukuk relationship depends on the underlying contract with which it is constructed. If the underlying contract is a musharaka contract, then there is a partnership relationship. In addition to that a sukuk also represents an ownership stake in the underlying asset. Sukuk can serve as an integrating tool between Islamic and conventional markets, basically because it can be structured in a way that resembles a similar risk/return profile as bonds.

3.2.1 Sukuk creation process

The design process of such instruments is similar to the process of securitization. The most prominent contract used in the process of securitization to create a sukuk is the mudarabah. The big advantage of mudarabah is that it gives the right to one party to act as an agent (manager) on behalf of the principal (investor) on pre-agreed terms, which makes the whole undertaking much easier. Similarly to a conventional special purpose vehicle (SPV), there is a special purpose mudarabah[15] (SPM), which is created utilizing the mudarabah contract. The SPM has to acquire certain assets and then issue certificates against these assets. The underlying assets need to be halal assets. The following steps show a generic structure of sukuk instruments and are based on the literature of Iqbal and Mirakhor (2011).

Step 1 An entity wants to free up its capital stock in a portfolio. For example, this portfolio consists of ijarah contracts, the assets might be tangible- (buildings, land, airports etc.) or intangible assets (stocks), both are accepted. Now the SPM which was created before acquires the particular assets which were already identified for a predetermined purchase price. The SPM is a separate legal entity and does not have to be affiliated with the originator. If the SPM is an independent entity, it carries the assets on its own balance sheet with its own credit rating, rather than on the balance sheet of the originator.

Step 2 The SPM issues certificates (sukuk) on its liability side to finance the underlying assets. The issued amount is equal to the purchase price of the underlying asset. The owners of the sukuk are all participating on the equity interest of the SPM's assets, therefore the certificates

[15] Term proposed by Iqbal and Mirakhor (2011)

are of equal value as the underlying assets. Like in a conventional securitization process it is possible to make tranches with different risk/return profiles to fulfill the risk appetite of different investors, but only if these investors are convinced to do such a separation.

Step 3 In this step the asset gets sold or leased to investors[16]. For example, in the case of ijarah contracts, the asset will be leased to a lessee or the originatior of the sukuk, who is liable for the lease payments. The lease payments are passed to the sukuk holders after deducting for some minor administrative, insurance and other servicing fees.

Step 4 To enhance the marketability and investment quality a third party, for example an investment bank, might issue a guarantee. This guarantee ensures the sukuk holders a specific performance, either to buy or replace the underlying assets in case of default. This credit enhancement makes the sukuk interesting for institutional investors because it might lift the sukuk to investment grade. However, such a guarantee cuts the direct link of risk and return of the asset with the certificate, which makes the sukuk more debt-like, because investors are not exposed to the risk of the asset, but to the credit worthiness of a guarantor. A guarantee leads, as expected, to a deduction of the performance of the sukuk.

Step 5 In most cases a sukuk embeds a put option for the holder, that means, that the issuer has to buy back the assets at a predetermined price. This protects the investors against capital loss. Therefore, at maturity the SPM starts winding up by selling the assets for a predetermined price. At maturity the SPM sells all assets and ceases to exist. However, this put option again raises the question of acceptability in Islamic finance, because the direct link between risk and return of the asset and the certificate is disconnected as well in such a case.

[16]Depending on the contracts with which the underlying assets are linked, e.g. ijarah

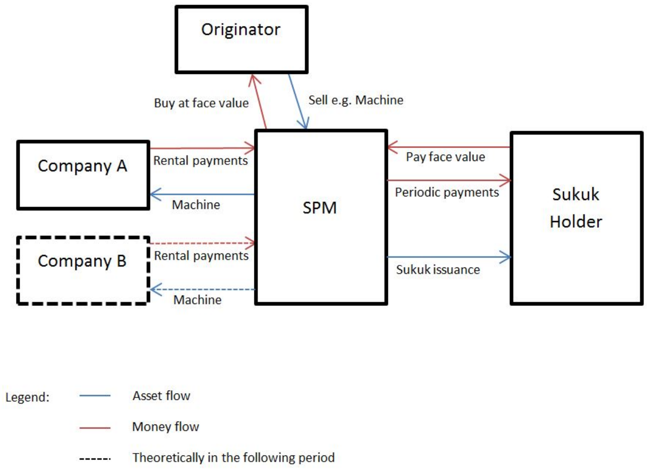


Figure 4: Basic sukuk structure with an ijarah contract

3.2.2 Resolutions on Sukuk

The Accounting and Auditing Organization for Islamic financial Institutions (AAOIFI) is a non-profit organization, that was established in Bahrain on 27 March 1991. Its aim is to maintain and promote Shari'ah standards for the whole Islamic financial industry. By now the AAOIFI counts 155 members from 40 countries, including central banks and other participants of Islamic finance and banking around the world. According to the AAOIFI sukuk is defined as:

> Certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity (see *Shariah Board Resolutions on Sukuk* (2008) p.1).

In 2008 the AAOIFI published a statement to provide some guidance in relation to sukuk structures, which will be highlighted in the following.

Recourse to assets It is crucial that investors of a sukuk become the owners of the pool of assets and the revenues and returns generated by them. To be tradeable, all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, owned and sold legally, must be transfered to the sukuk holder. This also means that the assets should be removed from the books of the originator and transfered to the books of the sukuk holder.

Representation To be tradeable, a sukuk has to represent the underlying assets and not receivables or debts.

Shortfalls Sukuk holders should not receive an offer for a loan if actual earnings fall short of what was expected. But it is allowed to build a reserve account to cover shortfalls, however this should be stated in the prospectus.

Repurchase At maturity the originator of the sukuk is not allowed to repurchase the assets at nominal value. However, they can repurchase the assets at their net value, market value, or fair value. Nonetheless the originator is also allowed to repurchase the assets under a pre-agreed price at the time of their first purchase.

Repurchase in case of ijarah In a *sukuk al-ijarah* the lessee is permitted to purchase the leased assets at maturity for their nominal value, as long as the lessee is not a partner, mudarib (investment manager), or investment agent of the sukuk.

Shari'ah Boards The Shari'ah Boards should do more than just publish legal opinions (fatwa) on the permissibility of the sukuk structures. The Shari'ah Boards should analyze all relevant contracts related to sukuk securities, and oversee the actual means of implementation.

3.3 Sukuk Types

There are several ways to create a sukuk. Sukuk provides the possibility for all individual investors to invest in Shari'ah conform products directly and to control what kind of assets to invest in. The alternative is to give their money to a bank on a retail instument basis, where the investors do not really know in what kind of assets their money is going to be invested. This section gives an overview on the types of sukuk and discusses their permissibility. What is common for all sukuk types, is that they have to be conform to Shari'ah principles. Secondly, the underlying assets must have some beneficial usage for the user.

3.3.1 Sukuk al-Ijarah

The most widespread form of sukuk is the so called sukuk al-ijarah, and both conventional and Islamic individuals and institutions have shown their interest in it. The basis for this type are ijarah contracts and investors are as mentioned above not directly linked to a company or institution. The holder of the sukuk has an undivided pro rata ownership of the underlying asset. There are some advantages which come with this kind of sukuk. First, it is most similar to conventional bonds, in that it provides both flexible and fixed payments. In addition, sukuk al-ijarah includes rental payments and a principal payment at maturity, what makes it even more appealing to international investors. Second, the sukuk al-ijarah provides option of extended maturity. This means that the ijarah contract is convenient for medium to long term financing. Third, the Shari'ah permits the sale of the leased security to other market participants, which is a critical feature for developing a secondary market.

However, as explained in section 3.2.1 a SPM is created. The assets owned on an ijarah basis are transeferred to the SPM which in turn sells certificates to investors. It is crucial that investors of a sukuk become the owners of the pool of underlying assets, to guarantee the direct link between risk/return profile of the asset with the sukuk. In fact, in most cases the investors do not have full ownership of the underlying assets, because they are structured in a way that insures the investors of capital loss, by a third party who acts as a guarantor. This has the effect that investors lose the direct risk/return profile of the underlying and are exposed to the creditworthiness of the guarantor, rather than the value of the underlying. The disconnection turns these certificates into asset-backed securities, rather than asset-linked securities[17], which raises the question if these "asset-backed sukuk" are still non-interest securities. To enhance the liquidity of a sukuk, there is also the possibility for a performance guarantee from a third party (or even from the originator of the sukuk). If a sukuk investor benefits from both types of guarantee (performance and resale) then he/she actually ends up giving money for a fixed rate and getting the principal back at maturity. In fact, with such guarantees, the undertaking becomes just a complicatedly structured loan. Therefore, to issue a purely Islamic financial product it is important that it comes without these guarantee features, even it is allowed as explained in section 3.2.2.

3.3.2 Sukuk al-Mudarabah

A sukuk al-mudarabah is also known as *sukuk al-muqaradah*, these kind of certificates have mudarabah contracts as underlying instruments. There is a mudarib (investment manager) who uses the money for a specific project on behalf of a pool of investors. The certificate owners are the legal owners of the asset used for the undertaking. Profit and losses are shared in a pre-agreed portion between the sukuk holders and sukuk issuer. A sukuk al-mudarabah can be issued by a company to finance a project, which can be separated from the company's general activities. At maturity the certificate holders have the right to sell their claim on a secondary market. However, this type of sukuk has never become very popular among investors. On one side there is a lack of transparency and on the other side a lack of liquidity.

Sukuk al-mudarabah reflects the partnership ideology of Islamic finance

[17]The difference is explained in section 3.1.2

very well. One of the reasons why this instrument did not gain much popularity is the lack of transparency. The mistrust in this certificate is further promoted by the feature that companies finance projects which end up disappearing from their balance sheets. From an agency theory perspective this is not very trust worthy, because it reflects an instrument which can be easily misused for risk shifting. If a project were good, a company would not want to remove it from their balance sheets. Any way mudarabah contracts depend heavily on the integrity of the mudarib (entrepreneur, investment manager) to really become accepted. It should be noted that sukuk are supposed to lower monitoring costs, even if they cannot be totally eliminated. Adverse selection will always exist, since mudaribs may be tempted to exaggerate their competence and willingness to act on behalf of the investors. In such cases it is auxiliary to have a track record, much as in private equity undertakings. The possibility of terminating the lending further reduces adverse selection. If this market were liquid and competitive, principals will get high information flow of the activities of the mudarib and the developments of the project. In addition, the threat of never finding a job as a mudarib in case of failure raises the pressure on the mudarib to deliver good results.

3.3.3 Sukuk al-Musharaka

In this type of certificate the underlying assets are musharaka contracts. They are quite similar to sukuk al-mudarabah, with the main difference lying in the form of partnership. In a sukuk al-musharaka the sukuk holders are the partners of the mudarib, similar to a joint venture. In contrast to a sukuk al-ijarah where the issuing volume is limited on the value of the underlying assets, the sukuk al-musharaka does not pose such a limitation.

Both mudarabah and musharaka sak (pl. of sukuk) are ideal for the promotion of Islamic finance. However, the same complications as in the mudarabah sukuk arise here. In most cases it lacks transparency and liquidity. If the monitoring and transparency of such instruments were enhanced, the acceptance and liquidity would grow, which in turn could lead to a bigger contribution to the developments of Islamic financial markets.

3.3.4 Sukuk al-Murabaha

As its name implies, sukuk al-mudarabaha is based on the cost plus contract. It refers to a sale of a good for a higher price than its original price negotiated in advance. It is convenient for short term financing. The advantage of this type of sukuk is that if an asset is too expensive to buy in a retail murabaha contract, then the initiator can issue a sukuk al-murabaha to gather additional financiers, who are willing to provide the additional capital. A sukuk al-murabaha delivers constant payments to its sukuk holders and it is non complex in structure. The various sukuk holders share the profit in proportion to their financial contribution.

Nonetheless, as this instrument is seen as debt, because it represents a monetary obligation, it can be sold only on a primary market. It can be traded only at face value, since any other price would be seen as an implicit interest. Since the underlying assets do not generate cash flows, sukuk al-murabaha holders are exposed to the credit risk of the initiator. Moral hazard is a big issue in these instruments, because the initiator (agent) may be tempted to conceal his actions out of self-interest. Of course the agent is aware of sudden stops in lending, but this kind of threat guarantees only a minimum effort of the initiator. Another way to align the principal's (sukuk holder) interest with the interests of the initiator is to use "outcome-based" and "behavior-based"control systems. In the end this is not the optimal instrument to promote Islamic finance, because it is too similar to conventional debt, which makes the real difference between interest-based and cost plus based finance hard to understand for non-Muslims.

3.3.5 Sukuk al-Salam

Sukuk al-salam are adequate instruments for short-term financing. The maturity ranges from three months to one year. Salam contracts are synonymous with forward contracts, however it is only allowed if gharar (uncertainty) is non existent in the contract. The salam contract constructs a trade between three parties with immediate payment and deferred delivery, where the SPM buys the commodity and then sells it to a third party on a pre agreed price. Usually, the commodity is sold to a discount to the SPM, the discount is generally calculated by using a reference rate (e.g. LIBOR). The profits are shared according to the proportion of the contribution of each sukuk holder.

This instrument is also seen as pure debt finance, since it represents only a financial claim. There is no real link between the asset and the risk/return profile of the commodity, since prices are fixed in advance. The AAOIFI Shari'ah standards sees the fungibility of debt as non Shari'ah compliant, therefore there is no secondary market for sukuk al-salam, which in turn partly explains why this product is not widespread. The main risk which comes with this instrument is the creditworthiness of the end beneficiary of the commodity. The beneficiary promises to buy the commodity from the SPM, since one can examine upfront if the beneficiary really needs this commodity or not[18].

3.4 Sukuk Payoff Profiles

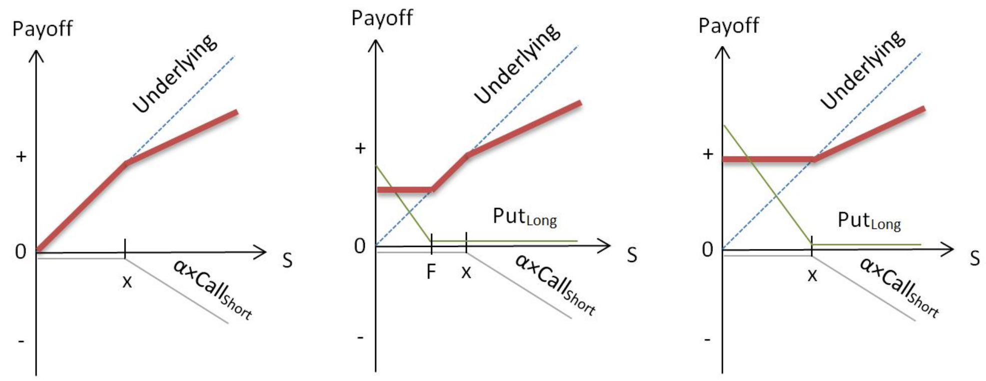
The following subsections will highlight the payoff profiles of the major sukuk contracts. For this purpose figures are used to visualize the facts from the perspective of an investor. The payoff profiles can be divided into profit sharing and mark-up, because all profit sharing payoffs and all mark-up payoffs look alike. The payoffs are disassembled into option payoffs, because one can look at the payoff as implicit option payoffs. This

[18]If the beneficiary is a manufacturer there is a high chance that he fulfills his promise, whereas an individual may be tempted by self-interest

makes it easier to understand the payoff and the incentives structure. Note that the figures are dissembled into sub figures (a), (b) and (c), whereas the payoff converges from (a) to (c) to a debt like instrument.

3.4.1 Profit Sharing Payoff Profiles

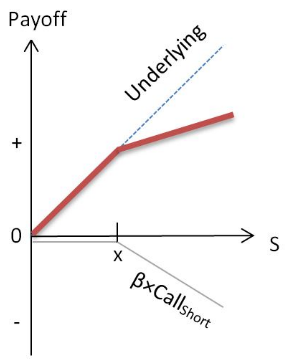
Figure 5 shows the payoff profiles of a sukuk al-mudarabah. The sub figure (a) shows a plain vanilla sukuk al-mudarabah payoff. The horizontal axis indicates the value of the underlying asset S, the vertical axis shows how much the investor receives for an increase in the value of the asset. At the beginning the payoff of the sukuk increases linearly with the underlying until break even, which is indicated by x. From then on the profits get split and the investor has to share with the mudarib. In principle the investor of a sukuk implicitly writes α ($0<\alpha<1$) call option with exercise price x (which is break even). If α would be 0 or 1 there would be no participation for one party. This is a strong incentive for the mudarib, since he only receives a real profit if he manages to be above break even.



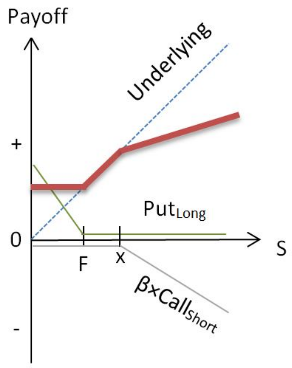
(a) plain vanilla (b) face value protection (c) full capital protection

Figure 5: Sukuk al-mudarabah

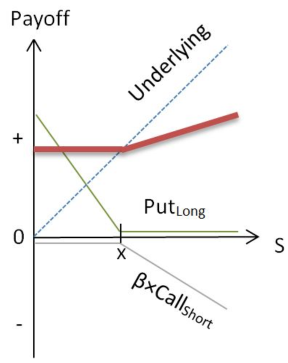
Sukuk al-musharaka, which can be seen in figure 6, look pretty much the same. The only difference is the distribution rate for the investors, which is smaller in a musharaka contract. This is mainly because the investor is able to take a hand in the business, therefore the participation raises only by $1-\beta$ ($\beta>\alpha$). Sub figures (b) and (c) show how the payoff changes, if the sukuk becomes more secure. Sub figure (b) shows the payoff with face value protection, so the investor will at least get his invested money back. This means, that the investor receives a put option (mudarib writes put option, or a third party), with exercise value F ($F = facevalue$). By doing so the investor loses the direct connection to the risk and return of the underlying. Sub figure (c) goes even further, by guaranteeing a fixed profit for the investor. This lowers the risk induced by the underlying asset and shifts the risk to a credit default risk.



(a) plain vanilla



(b) face value protection



(c) full capital protection

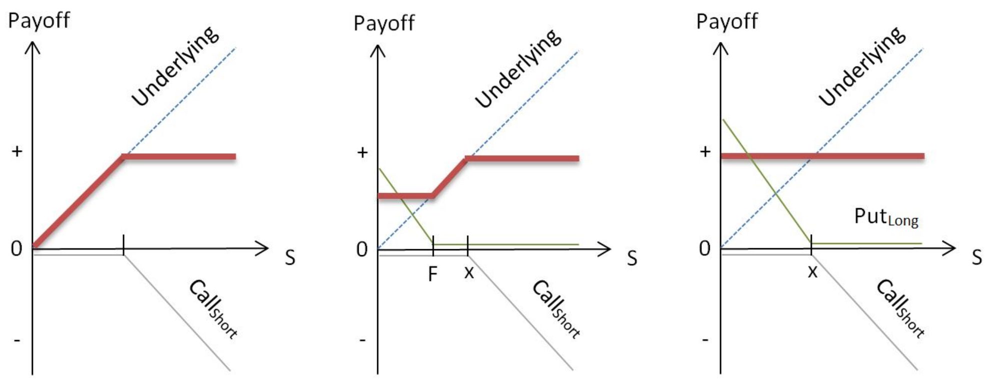
Figure 6: Sukuk al-musharaka

3.4.2 Mark-up Payoff Profiles

Remember that a mark-up product can be a sukuk al-ijarah, -murabaha or any other mark-up contract. Sukuk with a mark-up contract are very popular[19]. Sub figure 7 (a) shows the payoff profile of a plain vanilla product. The payoff looks like a bond payoff profile. This is actually the aim of a mark-up sukuk, but remember that instead of receiving predefined fixed amounts every year, a sukuk pays only what the underlying asset pays. Therefore the investor has a share in the risk of the real asset, whereas that is not the case in a conventional bond. The payoff profile

[19]e.g. in Switzerland sukuk al-murabaha are the most offered

of the sukuk is again shown as parts of option payoffs. In sub figure (a) the investor writes 1 call option with strike price x and cuts his upside potential return. There is no guarantee that the investor will get his initial investment back, since there is no protection. Sub figure (b) shows the payoff with face value protection, note that the payoff looks like a bull-spread, where the investor assumes that the market will just raise a little. This is often seen in short term products, where it is unlikely that there will be a big market movement in the short term. Note that sub figures (b) in every figure have the touch of a speculative products. And finally there is sub figure (c) where the investor receives a put option at x (which guarantees a profit), has an all flat payoff. Even if the background story of a sukuk suggests that there is a connection with the underlying, the investor has almost no connection to the underlying. Economically a sukuk al-murabaha (or any other mark-up sukuk) with profit guarantee is nothing else than a loan. At the end of the day the investor is exposed to the default risk of the guarantors (writer of the put option).



(a) plain vanilla (b) face value protection (c) full capital protection

Figure 7: Sukuk al-murabaha

These figures highlight why it is so important for the sukuk to come without any enhancements. With every enhancement Islamic financial products lose their initial aim and become more debt like. Even if the products with protections against loss are accepted among most scholars, economically they converge to conventional debt instruments the more protections are included.

4 Practical Application of Sukuk

This section will investigate the real world prospectus of sukuk, to see how far the sukuk originator fulfill the principles of Islamic Banking. The discussed documents contain extensive information about risk factors, structure diagram and cash flows, general description, applicable final terms and many more. However, to discuss all mentioned points would go beyond the scope of this thesis, therefore it will only highlight some major points and analyze their impact. Notice that the terms sukuk, certificate, fund and trust certificate are used interchangeably. Furthermore, only the pages are given for reference, since every subsection has only one reference document, which is mentioned in the subsection title.

4.1 Abu Dhabi Islamic Bank (ADIB) Sukuk Company Ltd.

ADIB is incorporated in the United Arab Emirates (UAE). It was established on 20 May 1977 in Abu Dhabi, by the government of Abu Dhabi. The main purpose of its creation was to become the leading Islamic bank in UAE. On 1 December 2006 they issued a base prospectus, which contains the most relevant informations for a trust certificate program. The SPM is called ADIB Sukuk Company Ltd., which is incorporated in the Cayman Islands. It will be a closed end fund with total capital of US$ 5'000'000'000. Certificates will be issued from time to time in various currencies, which makes it an international issuance program. The SPM buys ijarah contracts from the originator. However, the ijarah contract does not have one specific asset as an underlying (e.g. buildings, cars, machines etc.). HSBC will take the part of the dealer. The certificate will not include any performance guarantees, and will be issued at par, which is Shari'ah compliant. The "certificate will evidence an undivided beneficial ownership interest of certificateholders in trust assets of the relevant series, it is also evidence of limited recourse obligation of the issuer and will pari passu, without any preference or priority, with all other trust certificates of the relevant series issued under the program" (see p.20). The prospectus also contains a negative pledge which ensures that all certificateholders, no matter of which series, will be treated equal.

However, even if some points are fulfilled, there are many questionable aspects of the prospectus. First, the ADIB Sukuk Company Ltd. is located on the Cayman Islands. This is maybe favorable for the participants (in terms of regulation and taxation), but in fact this structure withholds tax income from the population of the origin country of the deal, when it is a well known fact that Islamic banking should be in favor of the whole society. Taxes are paid only by the investors, only if the country where the sukuk is allowed to be sold, demands for tax payments. Second, the SPM depends heavily on the originator (ADIB), whereas the textbook-example[20] stipulates the independence of the SPM from the originator. ADIB will be the managing agent of the SPM and additionally the SPM will receive the cashflows from ADIB and in a second step transfer them to the sukuk holders.

> Certificateholders will have beneficial co-ownership interests in the relevant co-ownership assets unless transfer of the co-ownership assets is prohibited by, or ineffective under, any applicable law (see p.9).

The certificates will be sold any way to someone who is willing to invest, but if the investor does not become the co-owner of the assets there is no link to the underlying which is crucial in Islamic banking. This opens the door for debt creation. Also, there will be no investigation from the issuers side as to whether the co-ownership assets may be transferred, or not. Certain assets may not be transferred under UAE law, such as buildings.

> Accordingly, no assurance is given that any co-ownership interest in the relevant co-ownership assets has been or will be transferred to the issuer (SPM) (see p.10).

[20]see subsection 3.2.1

The dependence on ADIB also leads to another problem, e.g. if ADIB becomes insolvent it is not clear how a claim on behalf of certificateholders against ADIB would be resolved. This document is governed by English law and to the courts of England having exclusive jurisdiction to settle disputes. However, even if a judgement may be obtained in an English court, there is no guarantee that ADIB has any assets in the UK against which such a judgement could be enforced. ADIB has most of its assets in the UAE and under UAE law, the courts are unlikely to enforce English law. The following citation will highlight the lack of transparency. The basic document is governed by English law, in contrast to the Master Purchase Agreement which is governed by UAE law. It is hard for an investor to keep the overview.

> The Master Purchase Agreement between ADIB, the issuer (SPM) and the trustee, as supplemented and amended from time to time, and each Supplement Purchase Contract applicable to a series of trust certificates are and will be, governed by UAE law (see p.94).

At maturity ADIB will pay

- the aggregate face amount and,
- the amount of payable but unpaid periodic distribution amounts on that date

The certificate does not have to last until maturity, because ADIB has the option to dissolute the sukuk before maturity. This resembles a callable bond in the conventional system. This clause further highlights the dependency of the SPM from the originator (ADIB). The last point which will be mentioned is concerning the periodic cash flow distribution. ADIB will receive a fixed basic fee of US$ 100 and a variable fee which is linked to the profit of the sukuk. These fees are meant to recoup ADIB for being the managing agent. First, ADIB has to pay all current cost of the underlying assets (insurance, maintenance etc.). Second, return on the account of profits has to be distributed among sukuk holders in proportion to their capital invested. And last if there is a residual amount left, the managing agent is allowed to keep it, as an incentive fee. Remember ADIB is the originator of the sukuk and the managing agent. This incentive structure gives room to enrich oneself at the cost of sukuk holders (particularly in these circumstances). ADIB knows the underlying assets best, so they can predict pretty precisely if they are able to meet the obligation in the sukuk contract or not. So if their underlying assets or their ijarah contracts would pay more than a bond on the international markets, they can construct the sukuk in such a manner that it just pays similarly to a conventional bond to attract enough international investors, but to keep the additional profits in their pockets. This additional incentive fee allows ADIB to double dip; first they sell their underlying and receive a principal, and second they still profit from their assets by receiving a profit share. As mentioned earlier, one of the basic principles of Islamic banking says that it is not allowed to enrich oneself at the cost of others. It is key in a sukuk contract that the originator has no power over the underlying assets once it enters the sukuk. So the assets have to be transferred to the sukuk company, but this is not the case here. In a nutshell, this contract provides some of the features of Islamic banking, but it also lacks to fulfill basic principles of Islamic banking, such as the transfer of the underlying assets on the books of the SPM. Since this is not guaranteed here, this whole contract emerges as an "asset-backed" instead of "asset-linked" security. ADIB remains practically the owner of the assets and acts as managing agent. In fact this leads to the issue, that the "sukuk" here depends on the creditworthiness of ADIB and delinks the risk/return profile of the underlying asset with the certificate.

4.2 National Industries Group Sukuk Company Ltd.

National Industries Group Holding Company S.A.K. (NIG) was found to engage in the upcoming infrastructure industry in Kuwait. It was also established to promote the industrial advancement through innovative developments in the materials, engineering, utilities and many more industries. NIG is partly state owned, nowadays it is one of the largest listed holding companies on the Kuwait Stock Exchange in terms of total assets and shareholdings, which are fully or partly owned companies. In 2007 they decided to launch a sukuk company for the purpose of new developments which is located on the Cayman Islands. First, an SPM was created, which they called NIG Sukuk Company Ltd. It is key to understand that in this case the underlying assets are mudarabah assets. Therefore this is a sukuk al-mudarabah. Remember that this kind of investment is fundamentally different from the previous case where we looked at a sukuk al-ijarah. The originator (NIG) needs money for a new project, which they will get through the sukuk. NIG will be the mudarib and manage the whole project. The sukuk company will issue certificates with a cumulated amount of up to US$ 1'500'000'000 (or its equivalent in other currencies). Investors from all over the world may participate in this investment, since it is set up globally and the certificates may be traded on the London Stock Exchange's Gilt Edge and Fixed Interest Market. In contrast to the previous case the SPM will have all mudarabah assets on its own account. The sukuk company will enter in the mudarabah agreement on the basis of the projected return set out in the investment plan. They will only agree if the projected return is attainable, although this is no guarantee for the sukuk holders to enter into a successful investment. The distribution of payment works as follows, the mudarib (NIG) will have the obligation to make payments under the mudarabah contract. The sukuk company collects all payments and distributes it to the sukuk holders. In fact the certificate issuer is not allowed to make any actions which are not compliant with the purpose of the undertaking. The only thing which the sukuk company has to do is to serve the certificate holder, to act as a trustee and to calculate and distribute the payments according to the stake which each investor has.

> Each of the trust certificates will represent an undivided beneficial ownership (real ownership) interest in the trust assets which are held by the trustee on trust ... (see p.33).

As mentioned above the ability of the sukuk company to make the payments due on the trust certificates will heavily depend upon receipt by the sukuk company from NIG. Certificate holders will therefore bear all the entrepreneurial risk. Other interesting risk factors for the certificate holders are the following. In case of bankruptcy the certificate holders only receive money in extent to what the Kuwait law permits. In particular this means that if there are any wages for employees unpaid, then NIG first has to pay their employees and only afterwards the sukuk company. This highlights also the entrepreneurial risk which a sukuk holder faces. Other enforcement risks imply that if NIG fails to make the payments then it might be time consuming but in contrast to the previous case, jurisdiction is not as complicated

> NIG has irrevocably agreed to certain documentation being governed by English law and to the courts of England having exclusive jurisdiction to settle disputes. Kuwait and the United Kingdom are both signatories to the 1958 New York Convention on the Recognition and Enforcement of foreign Arbitral Awards (the New York Convention) (see p.13).

This means that any decision which was made by English law has to be enforced in Kuwait and the United Kingdom as long as it complies with certain enforcement conditions. However, a 100% assurance whether an English court judgement will be enforced in Kuwait can never be given, but it is a milestone compared with ADIB Sukuk Company where investors have no such covenant. The New York Convention helps to facilitate the issuance of sukuk in a global environment.

The capital of the sukuk holder will be invested according to the investment plan. The investment plan permits NIG to invest in certain general business activities of NIG. This point is somewhat problematic, since this structure can lead to embezzlement. In principle a mudarabah contract is meant to be invested in one specific project. If the covenants allow for investments in two projects (where the second is not particularly specified), the mudarib has the possibility to invest part of the capital in assets which would not have found any investors otherwise. Therefore there is the chance for cross-financing, which can lead to higher risk for the sukuk holders and thus to a shift of wealth from sukuk holders to the shareholders of the mudarib (see Amihud and Lev (1981)). In case of higher returns than expected the mudarib shall be entitled to these excess profits for its own account. This is meant as an incentive fee for acting as a mudarib. In the previous case the mudarib also had an incentive fee, but unlike in the previous case it can be seen as a positive thing. Remember in this case sukuk holders invest in mudarabah contracts which are highly entrepreneurial and risky. It is also in the mind of sukuk holders if the mudarib has an additional incentive for working even harder and mitigate moral hazard. However, if the distributional profit is lower than the projected return, the mudarib shall have an obligation to ensure that this discrepancy in return will be closed for the sukuk holder. Of course this is no guarantee but it helps to mitigate exploitation by the mudarib. At maturity the originator has also agreed to buy back the rights, benefits and entitlement of the sukuk company. The price payable will be up to the aggregate face amount plus the amount of accrued and payable but unpaid periodic distribution amounts. There is also a dissolution option for NIG. If dissolution happens at maturity or prior to maturity the sukuk company ceases to exist and all certificates which are redeemed will further be canceled and destroyed.

The NIG Sukuk Company Ltd. is much nearer to the philosophy of Islamic capital market products than the ADIB Sukuk Company Ltd. But even NIG is far from perfect. There are some aspects like the transfer of assets from the originator to the sukuk company which is fulfilled. There are also some facilities like the New York Convention which makes the contract more transparent and pushes equal treatment further. Anyway, there still exist some covenants which delink the risk/return profile of the asset with the sukuk. For example that sukuk holders have the right to receive the face value of the assets which they invest in. It would be better if sukuk holders would receive the fair value of the assets at the end of the sukuk's lifetime instead of a predicted amount which protects the sukuk holders from capital losses.

4.3 Products in Switzerland

This subsection and subsection 4.3.1 are carried out by interviews with leading Swiss bankers and the documents which they provided. They agreed to an anonymous interview under the condition that it is disclosed that their statements are not representative for their employers. The complete interviews can be found in the appendix 6, 7 and 8.

The two most common ways how to invest in Switzerland in Shari'ah compliant products is by investing in an Islamic equities fund (e.g. Morningstar (n.d.*b*), Morningstar (n.d.*a*) or UBS (n.d.*b*)) or by commodity murabaha (see CreditSuisse (n.d.)). The second investment has a short term (up to one year) and the first a long term character. The equity funds try to replicate an index or only invest in particular stocks from these indexes. These are individualized offerings or special mandates portfolio management which Swiss banks provide. The portfolio solution is rather a service than a product, which is only offered on request of a client. The products which are most offered by UBS are sukuk al-murabaha or short term deposit products which are based on commodity murabaha (simple murabaha which uses commodity as underlying). These products are structured as follows:

Under the terms of the product (see UBS (n.d.*c*)) the agent (UBS AG, Zurich) buys a commodity on behalf of the investor, which will be immediately resold to UBS AG, Jersey (the buyer). Note that these two banks are separate acting banks, which means that the investor is exposed to UBS AG, Jersey and has no claims on UBS AG, Zurich if something happens. Whilst the investor pays the spot price for the commodity, he/she will receive the amount for reselling on a deferred basis (face value and profit). These are all tailor made products, and are offered over the counter, therefore no secondary market exists. All of the "Swiss" sukuk al-murabaha products which were analyzed in this thesis have in common that the face value is guaranteed. In some cases there is also a guaranteed minimum return. In these cases UBS AG, Zurich is the Agent and has the power and the right to act for the account and in the name of the principal. The agent is not under a liability contract, this means that the investor, is exposed to the credit risk of UBS AG, Jersey only. UBS AG, Zurich and UBS AG, Jersey are both part of the same legal entity but are acting on different behalf. For each trade which is done under sukuk, there needs to be a proof that the transaction really happened and that ownership changed. The agent is in charge of documenting all transactions. The agent will receive a agency fee for this service. The big advantage between these contracts and the other described in section 4.1 and 4.2 is that the governing law is clear. All disputes have to be settled under the law of Switzerland in the courts of Zurich.

The products provided here are transparent solutions for the client. The investor knows under which law any disputes will be settled and therefore have the comfort that there is no doubt whether the law will be enforced or not. The products are also very transparent with respect to the transaction, since the agent has to document every transaction and has to verify any transfer of ownership, which is crucial in Islamic banking. However, all of these contracts promised to protect the face value and pay it back at termination of the contract. Some of the contracts also promised a minimum return, which in fact takes the entrepreneurial risk and transform the whole undertaking into a conventional credit (at least from an economic point of view).

4.3.1 Islamic Banking in Switzerland

Switzerland is one of the countries with the highest reputation in financial markets. Switzerland is characterized by low level of red tape, excellently trained and well motivated labour and prestige. In fact there is no legal restriction to establish banks which solely operates in a Shari'ah compatible fashion. The Swiss financial market supervision (Eidgenössische Finanzmarktaufsicht, FINMA) investigates if an operating bank in Switzerland comes into conflict with the law. As soon as the FINMA allows a bank to operate in Switzerland, the products which they offer are automatically accepted, too (see Aichbichler (2009) p.79). Investment funds are an exception from this rule, as each of them have to be controlled by the FINMA. The general principle in banking regulation in Switzerland is that all banks must be treated the same. In 2010 4.3% of the Swiss population, or 310'807 people were Muslims (see Bovay and Broquet (2004) p.12). Most of them come from Ex-Yugoslavia and Turkey. This is quite a low potential for Islamic retail banking, even in Arabic countries where almost 100% of the population is Muslim, Islamic banks only have a market share of about 33% (see Grotewohl (2012) p.11). Nonetheless, Switzerland has a great potential for being a center of Islamic banking, not only because of its above mentioned characteristics but also because of its neutrality which makes it even more favorable than London (see Wilson (2004)). Because of the low potential of retail banking, Switzerland has focused only on private banking for the Muslim customers. Geneva is traditionally an important contact point for investors from the Middle East (see Wilson (2007)). Most Islamic banks and consultant offices are located in Geneva. It is no surprise that the first bank to operate under Shari'ah teaching was located in Geneva, namely Faisal Private Bank SA[21]. Aside from UBS and Credit Suisse which have been engaged in the Middle East for about 30 years, and actively structuring Islamic financial products for their customers in the Middle East, not many Swiss private banks have taken the risk with Islamic banking. Islamic banking in Switzerland is mostly driven by customers who wish to invest in Shari'ah compliant products. Before 2004 the bank Pictet provided a standard Shari'ah compliant capital market product, which they finally stopped after 2004. To create an interest free product in a conventional banking environment there are some adjustment to be done, which are cost intensive for the banks and thus lower returns. Radan Statkow, from Bank Bodier claims that only 10%-20% of the capital of Muslim high-net-worth-individuals (HNWI) are invested in Shari'ah compatible products. In addition to this, these HNWI only invest with banks from their home countries in Shari'ah products, as they care to invest that money in their home countries' economy (see *Islam-Banking: Im namen Allahs* (2004)). Furthermore business in the

[21]Does not exist anymore in Switzerland

gulf region depends heavily on trust and reputation, which is hard to gain in a short time, claims Alexander Theocharides from Faisal Private Bank SA. (see *Islam-Banking: Im namen Allahs* (2004)). Since 2013, Islamic banking growth slowed down. Many of the Swiss players stopped their investments and just keep it on the back burner. Bank Sarsin & Cie AG is one of the banks which still believe in Islamic banking and keep investing in it. Their aim is to build up the first complete islamic Private Banking offering in Switzerland. Many of Bank Sarasins Swiss rivals wait to see what is going to happen with Sarasins "experiment" before they start to expand in this area.

Summing up, Islamic retail banking has little to no chance in Switzerland; the focus must be on private banking (see appendix 6, 7 and 8) . Due to its long tradition and expertise in banking, Switzerland has great potential for becoming one of the centers for Islamic banking outside Muslim countries. However, in order to do so it is very important to start building a reputation in the Muslim world for Islamic banking, otherwise it will be very difficult to keep up in this segment.

5 Discussion

Islamic economics and especially Islamic finance is an alternative way to develop an economy and its financial system. It stands for an egalitarian social structure in which all men and women can maximize their potential in all aspects (see Askari et al. (2010)). The purpose is to create an economy which hinders the exploitation of one individual by another. Interest is seen as an instrument of exploitation and therefore needs to be abolished. The text-book version of Islamic finance differs substantially from conventional finance.Yet the practical application of Islamic finance is far from the initial idea. The products available at the time still violate key features of Islamic banking, such as transfer of ownership from the originator to the sukuk holder. In addition, there are often capital protections implemented in the sukuk contracts. These facts make it impossible for the investor to bear the risk/return profile of the underlying asset, which is key in Islamic finance. Not being too different from conventional products makes it easier for Islamic products to develop fast and gather many investors. This strategy is however a double-edged sword, on the one hand it makes the ideology easily understood and helps it become important for the economy. On the other hand though, it appears inconsistent, which can destroy faith in these products. To increase trust and, implicitly, the willingness to invest in this field, it is key for Islamic financial institutions to agree on common standards for Islamic products. In other words, Shari'ah authentication should be centralized. In addition, it is crucial to educate the investors and general public as to the nature and purpose of Islamic finance products, therefore striving to enhance the pool of potential investors. This will also ensure that new products become more compatible with the original requirements of Islamic banking.

Another important issue in the sukuk market is the transparency of these products. In general, they tend to lack transparency and thus mainly attract risk loving investors. This then makes the sukuk more illiquid since most investors are risk averse, which then has the overall effect of hindering Islamic banks from growing and developing. Products should become more understandable and transparent to ease the growth of the market.

Finally, the paper presented an analysis of Islamic banking in Switzerland. There is no real activity in this field although the circumstances for Islamic banking are good given that, Switzerland is one of the leading countries in financial services. There is a general skeptical view regarding this area of activity which may prevent the development of this type of banking. Customers drive Islamic banking in Switzerland and this will also be true in the near future. One of the biggest problems in my view is that Islamic financial market products are seen as exotic. People do not really know them and therefore do not use them often. In addition, investors who wish to invest in the Islamic way would rather do so in their home countries than in Switzerland. As mentioned earlier, Islamic banking is new and therefore changes very fast. As one of my interview partners said, "what used to be Shari'ah conform last year does not have to be conform this year" (see appendix 6).

Overall, Islamic banking has great potential for the future but there is a need for more of a consensus on its definition and application in order to maintain its original purpose.

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6 Appendix

- Which Islamic banking products are offered?

  Our bank mainly offers sukuk al-murabaha, which use a commodity as underlying. Furthermore we also offer portfolio solutions. Whereas the latter is no product as such, it is rather a service. In general these portfolios are exchange traded funds (ETFs), which try to replicate a Shari'ah conform index out of stocks and sukuk.

- Which products are more favored?

  Above all else, the demand is highest for short term products (3 to 12 months), like the already mentioned sukuk al-murabaha.

- Which financial institutions are most involved in Islamic finance?

  Particularly, those of Islamic countries. In Switzerland the UBS and Credit Suisse (CS) offer such products, but only on request of the customer. These products are not structured by BNP Paribas. Therefore these banks only procure Islamic banking products. Note that BNP Paribas structures these products for any amount wished by the customer.

- What opportunities does Islamic banking have in Switzerland (Retail-, Private Banking etc.)?

  Islamic banking will continue to stay a niche product in Switzerland. The basics (Know-how and potential in terms of customer size) do not exist in sufficient amount to become a hub for Islamic banking.

- Swiss banks were at the beginning of Islamic banking very reserved. Since 2013 the already small engagement has become even smaller.

  - What are the reasons for that?

    People prefer avoiding things, which they do not know.

  - What is in your view the biggest Problem?

    Islamic banking is still insufficiently developed. What used to be Shari'ah conform last year does not have to be conform *this year. This industry is growing, but unfortunately no one really knows how fast it is growing, since the database for these estimates is not reliable.*

- The FINMA is responsible for regulating the overall banking sector in Switzerland. In contrast to that, Shari'ah Boards are liable to decide if a product is conform with Islamic teachings or not and therefore implicitly regulate the Islamic banking sector.

  - Are these institution opponents to each other?

    In principle not, because they follow different aims.

  - Concerning what is right or wrong in Islamic banking there are different views from the existing Shari'ah Boards, since every bank has its own board. Is the development of Islamic banking slowed down by such disagreements?

    In principle not, because these Shari'ah Scholars are members of many boards. So it is likely, that you'll find a scholar sitting in one board also sitting on the board of another bank. Finally the customer decides on its own if he/she wants to trust these boards and invest or not.

- What was the reaction from Islamic customers to the last anti-Islamic initiatives (minaret ban, burka ban in Ticino). Where there any reactions?

  No.

- Switzerland enjoys a high reputation when it comes to banking. On the one hand through its tradition of discretion and the liberal economic environment and on the other hand through a secure political situation. This made Switzerland one of the most favored "safe harbors" in the world.

  - Why do not banks or companies offer sukuk with Swiss real estate as underlying? Is there already "enough" money in

Switzerland, which makes it hard to handle more money because of too few capacities, or is the additional effort not worth to create a sukuk relatively to traditional products.

In my opinion (conjecture): Good idea, but probably the fear of too few investors is too high. And nobody is willing to take the risk.

- Unfortunately there are great tensions in the Middle East at the moment. Is that an opportunity for Swiss banks?
  - Could one register more business activity in Swiss Islamic banking?

    As I understand it: no, as long as there is no sanction which hinders a bank to make business, but this wouldn't be a product specific problem.
- Currently there is a "watch and wait" situation in Switzerland about Islamic banking. Everybody is observing their competitors and watches how he is doing with Islamic banking. There is no real active engagement in that area. Banks only offer products on request of a customer.
  - What do you think of the future of Islamic banking in Switzerland?

    The market for Islamic finance will still be a growing niche, but Swiss banks will maintain offering only on request of customers. Noriba was unfortunately a disappointment.
- Knowing that Islamic customers value relationships between market participants higher than in western countries.
  - Aren't Swiss banks running the risk of being too late, to position them self and building a good reputation in these markets?

    Swiss banks will only start to invest real money in this sector, as soon as the sector has fully developed. The risk to invest in *an own Islamic bank is too high, as one could have seen with Noriba. Such an undertaking needs a long breath, which listed companies cannot provide.*

- Is there any interest from non-Islam Swiss customers for Islamic products?

  There is an interest on social responsible investments, which is comparable to Islamic banking. Until now I haven't seen any non-Islamic customers which asked for Islamic products.

7 Appendix

- Which Islamic banking products are offered?

  In general all Islamic banking products can be offered in Switzerland, as long as the compliance of the bank is maintained.

- Which products are more favored?

  No answer.

- Which financial institutions are most involved in Islamic finance?

  I do not know any Swiss bank which provides at the moment a full-fledged Shari'ah conform service line.

- What opportunities does Islamic banking have in Switzerland (Retail-, Private Banking etc.)?

  There is no potential for Islamic retail banking in Switzerland. Investments in Islamic products are driven by request of customers. In principle it is possible to manage a portfolio which is only invested in Shari'ah conform products. Therefore one will find Islamic banking only at private banks.

- Swiss banks were at the beginning of Islamic banking very reserved. Since 2013 the already small engagement has become even smaller.

  - What are the reasons for that?

    In the 1990s everybody in Switzerland was talking about Islamic banking. Unfortunately nothing happened from then on, because there was too little interest from customer side.

  - What is in your view the biggest Problem?

    In general Islamic customers do not fly to Switzerland to invest in Islamic products. They do this at home, where Islamic banking is no exotic business and people have a better know-how. Foreign customers generally come to Switzerland to invest in products or services for which Swiss banks are well known for (e.g. inheritance planning).
    The structuring of Islamic capital market products is too expensive in Switzerland, simply because know-how on this topic is scarce.

- The FINMA is responsible for regulating the overall banking sector in Switzerland. In contrast to that, Shari'ah Boards are liable to decide if a product is conform with Islamic teachings or not and therefore implicitly regulate the Islamic banking sector.

  - Are these institution opponents to each other?

    No.

  - Concerning what is right or wrong in Islamic banking there are different views from the existing Shari'ah Boards, since every bank has its own board. Is the development of Islamic banking slowed down by such disagreements?

    It would be certainly an advantage, if these disagreements wouldn't exist.

- What was the reaction from Islamic customers to the last anti-Islamic initiatives (minaret ban, burka ban in Ticino). Where there any reactions?

  No answer.

- Switzerland enjoys a high reputation when it comes to banking. On the one hand through its tradition of discretion and the liberal economic environment and on the other hand through a secure political situation. This made Switzerland one of the most favored "safe harbors" in the world.

  - Why do not banks or companies offer sukuk with Swiss real estate as underlying? Is there already "enough" money in Switzerland, which makes it hard to handle more money because of too few capacities, or is the additional effort not worth to create a sukuk relatively to traditional products.

    See above "What is in your view the biggest Problem?"

- Unfortunately there are great tensions in the Middle East at the moment. Is that an opportunity for Swiss banks?

  - Could one register more business activity in Swiss Islamic banking?

    No answer.

- Currently there is a "watch and wait" situation in Switzerland about Islamic banking. Everybody is observing their competitors and watches how he is doing with Islamic banking. There is no real active engagement in that area. Banks only offer products on request of a customer.

  - What do you think of the future of Islamic banking in Switzerland?

    Islamic banking will probably only stay in the area of private banking.

- Knowing that Islamic customers value relationships between market participants higher than in western countries.

  - Aren't Swiss banks running the risk of being too late, to position them self and building a good reputation in these markets?

Customers who want to invest Islamic do it in their home countries (outside Switzerland), simply because they trust these bankers more, when it comes to Islamic banking. Customers which live in Switzerland and want to invest Islamic, have in general a network to Islamic banking in their home countries (because they originally come from these countries).

- Is there any interest from non-Islam Swiss customers for Islamic products?

  No answer.

8 Appendix

- Which Islamic banking products are offered?

  There are three main products which we offer in Switzerland. First there is a murabaha contract, which we offer to private- as well as institutional clients. The second is reverse murabaha which is more a financing product, than an investing one. Third, we offer sukuk al-murabaha to institutional clients. Besides this, we also do portfolio management where we invest only in Shari'ah compliant securities for our clients.

- Which products are more favored?

  The demand for these products is more or less equal. However, at the moment there is a strong preference to financing products (reverse murabaha). The reason for this is that it is closely related to interest rates and in times of low rates investments become less attractive but in contrast to that financing attractiveness increases.

- Which financial institutions are most involved in Islamic finance?

  UBS and Credit Suisse (CS), as well as Sarasin. However, I'm not sure how big the exposure of these banks is. CS is one of the Swiss banks which do everything from structuring to distribution by themselves.

- What opportunities does Islamic banking have in Switzerland (Retail-, Private Banking etc.)?

  The opportunities in Switzerland are very limited. Our bank provides its Islamic platform not only to Swiss clients but to the whole world.

- Swiss banks were at the beginning of Islamic banking very reserved. Since 2013 the already small engagement has become even smaller.

  - What are the reasons for that?

    For our bank this is not the case. In fact our Islamic banking business is doing well with growth rates of 15%-30%. However, this is our overall Islamic banking business, in Switzerland the demand for Shari'ah conform products is low.

  - What is in your view the biggest Problem?

    The overall cost to provide such products are pretty high compared to conventional products. Islamic banking is still a niche business. The minimum amount which needs to be invested is 5'000'000 CHF.

- The FINMA is responsible for regulating the overall banking sector in Switzerland. In contrast to that, Shari'ah Boards are liable to decide if a product is conform with Islamic teachings or not and therefore implicitly regulate the Islamic banking sector.

  - Are these institution opponents to each other?

    No, in principle Shari'ah Boards only confirm if a product is Shari'ah conform or not. The overall financial sector in Switzerland is still subject to supervision by the FINMA.

  - Concerning what is right or wrong in Islamic banking there are different views from the existing Shari'ah Boards, since every bank has its own board. Is the development of Islamic banking slowed down by such disagreements?

No, generally not. However, the decision of the client if he invests or not can take more time, depending on how conservative he/she is.

- What was the reaction from Islamic customers to the last anti-Islamic initiatives (minaret ban, burka ban in Ticino). Where there any reactions?

  No impact at all.

- Switzerland enjoys a high reputation when it comes to banking. On the one hand through its tradition of discretion and the liberal economic environment and on the other hand through a secure political situation. This made Switzerland one of the most favored "safe harbors" in the world.

  - Why do not banks or companies offer sukuk with Swiss real estate as underlying? Is there alredy "enough" money in Switzerland, which makes it hard to handle more money because of too few capacities, or is the additional effort not worth to create a sukuk relatively to traditional products.

    Mostly because of the relative high costs. The second reason might also be, because it is just too little known.

- Unfortunately there are great tensions in the Middle East at the moment. Is that an opportunity for Swiss banks?

  - Could one register more business activity in Swiss Islamic banking?

    No.

- Currently there is a "watch and wait" situation in Switzerland about Islamic banking. Everybody is observing their competitors and watches how he is doing with Islamic banking. There is no real active engagement in that area. Banks only offer products on request of a customer.

  - What do you think of the future of Islamic banking in Switzerland?

    Internationally it will continue to grow very fast, but in Switzerland the demand for these kinds of products is just too low.

- Knowing that Islamic customers value relationships between market participants higher than in western countries.

  - Aren't Swiss banks running the risk of being too late, to position them self and building a good reputation in these markets?

    Our bank is still engaging in this field.

- Is there any interest from non-Islam Swiss customers for Islamic products?

  No, the interest comes primarily from Middle East, Asia and South America.