

# **ISLAMIC FINANCE AND ITS RELEVANCE TO CANADIAN FINANCIAL SYSTEM**

by

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## **ABSTRACT**

The study examines the concept of “Islamic Finance” and its relevance to the Canadian Financial System. Islamic Finance has been practiced successfully in the Muslim countries for the last few decades and is now migrating into the western financial system. An analysis of Islamic banks compared with conventional banks shows that Islamic banks are less volatile in terms of profitability indicators and more liquid. A comparison of Islamic mutual funds compared with conventional mutual funds shows that performance is as good as conventional mutual funds, given that they are passive funds they do not attract much trading costs. A study of development finance institutions like Aga Khan Development Network (a microfinance program) shows that a microfinance program rooted in Islamic finance can perform as efficiently (in fact better) compared to a conventional microfinance program.

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## **ABBREVIATIONS**

PLS:	Profit Loss Sharing
GCC:	Gulf Corporation Council
OPEC:	Organization of Petroleum Exporting Countries
AAOIFI:	Accounting and Auditing Organization for Islamic Financial Institutions.
GAAP:	Generally Accepted Accounting Principles
OIC:	Organization of Islamic Countries
CMHC:	Canada Mortgages and Housing Corporation
CDIC:	Canadian Deposit Insurance Corporation
TFSA:	Tax Free Savings Account
DJIM:	Dow Jones Islamic Index
IMUS:	Islamic Market US Index
IMTEC:	Market Technology Index
IMCAN:	Islamic Market Canadian Index
MER:	Management Expense Ratio
ICI:	Investment Company Institute
AKFED:	Aga Khan Fund Economic Development
AKAM:	Aga Khan Agency for Microfinance
AKF:	Aga Khan Foundation
AKHS:	Aga Khan Health Services
AKTC:	Aga Khan Trust for Culture
AKU:	Aga Khan University
UCA:	The University of Central Asia

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Sincerely,

Imtiaz Chaudhry

# **CHAPTER 1**

## **INTRODUCTION**

The term “Islamic Finance” is not very common in the global financial system; 20 percent of the world population is Muslim but only 1 percent of the world financial instruments are represented by Islamic finance (Rarick, 2009). “Islamic Finance” is the financial system that is consistent with Islamic Laws (Shariah), principles that ban interest and speculation and stipulates that income must be derived as profits from shared business risk (Jobst, 2007a & b;). Islamic finance is not only limited to banking. It also covers various financial markets including: bond, equity, mutual funds, and mortgages markets. (Khan, 1986; Hassan, 2001). Islamic finance is similar to ethical funds. Although the criteria for investment selection and modes of financing are different, the screening and reporting techniques are similar and important to both groups of investors (Wilson, 1997).

In the last five years, Islamic finance has grown by 15 to 20 percent annually, with an estimated \$270 billion in assets controlled by approximately 300 Islamic banks in more than 25 countries (Schmith, 2005). There are three countries (Pakistan, Iran, and Sudan) where the entire financial system is based on Islamic (Shariah) principles. In the other majority of Muslim countries, the financial system is dominated by conventional financial institutions. In some of the countries, the conventional financial institutions are operating alongside the

Islamic financial institutions. Financial globalization has facilitated greater diversification of investments and, globally, the Islam financial framework is one of the vehicles through which risk is transferred across national borders. In fact it is claimed that in recent periods, the growth of Islamic income funds has outpaced the growth of the overall mutual fund industry<sup>1</sup>. The potential for growth in the Islamic finance sector is significant and this rapid growth has raised a number of important questions. First, the growth in Islamic finance drawn by the comparative advantages of the Islamic financial institutions. Second, should the Islamic financial institutions be regulated differently from their Western counterparts?

The major segment of the Islamic financial institutions is the Islamic banks, which are operating in over 60 countries with most of them are heavily concentrated in Asia or Middle East (Zaman, 2001). Islamic banking is noted as “The fastest growing segment of the credit market in Muslim countries that have Islamic banks: their market share has risen from 2 percent in the late 1970’s to about 15 percent today” (Aggarwal and Yousef, 2000). Some funds under Islamic management are increasing at the rate of 15-20 percent a year (The Banker, 2000).

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<sup>1</sup> See <http://www.islamicfinance.de/?q=node/2005> (Accessed on March12,2011)

In Canada, the existence and growth of Islamic finance is substantial. Many Shariah compliant mortgages and other investment products are available (<http://www.Ijaraloans.com>) The chartered banks in Canada have evinced interest in offering Shariah compliant financial products such as mutual funds or mortgages as part of their expansion plans.

The performance of Islamic financial institutions as newcomers to the financial market has been viewed sceptically by traditional institutions and there could be several reasons. First, Islamic financial institutions are non-conventional financial institutions, where charging interest is completely prohibited on moral and religious grounds. Second, most of the Islamic financial institutions operate under dual regulations as they have to follow both conventional and Islamic laws. Third, the Islamic banks must ignore many profitable investment opportunities that are not permitted under the Shariah law of Islam (Samad, 2004).

This study examines the relevance and feasibility of introducing Islamic Finance into the Canadian context. To this purpose we use a case study framework and make a competitive study of mutual funds and developmental finance (microfinance program) under the conventional and Islamic finance frameworks. The main aim of this study is to analyze the drivers of growth behind Islamic finance in a changing competitive environment and to explore potential sources of differentiation for Islamic finance as well as the challenges that are unique to Islamic finance. The study will also examine the potential

growth of Islamic finance in the Western financial system and identify methods that can be successful in the Western financial system.

This thesis is organized as follows: Chapter II will discuss the main differences between the Islamic and conventional financial systems and the evolution of Islamic finance in the modern financial system. Chapter III is devoted to a review of the relevant literature. Chapter IV discusses the data base and methodology of the study. Chapter V discusses Islamic finance and its development in the Western financial system. Chapter VI discusses the case study of Islamic funds and describes the required performance measures. Chapter VII discusses the case study of Agah Khan Development funds (“Microfinance Program”). Chapter VIII discusses the future of Islamic finance. Finally, Chapter IX presents the conclusions and recommendations.



## **CHAPTER II**

### **WHAT IS ISLAMIC FINANCE**

Islamic finance and its financial instruments identify itself with the guidance of Shariah. It is laid down by the “Holy Quran and Sunnah” in its objectives, principles, practices and operations. Islamic finance could be viewed as a form of ethical screen and is based on the principle that no loans are possible unless they are interest-free. In order to replace the interest, the ideal mode of financing is the “Financing on Profit & Loss Sharing” (PLS) basis which will be discussed in greater detail later in this chapter.

This chapter is organized as follows: Section 2.1 describes the evolution of Islamic finance. Section 2.2 describes Islamic finance concepts and principles, and section 2.3 describes the principles of the Profit Loss Sharing (PLS) basis.

#### **Section 2.1: The Evolution of Islamic Finance**

Islamic finance was first established in Egypt in 1963 by the name of Mit Ghamr Savings. The focus was not only deposit money into the bank and ensure that they respect Islamic values concerning interest, and also to educate people about the use of banking. Paying and earning interest was not allowed on these deposits, only withdrawals could be made on demand. Mit Ghamr Savings became very successful as the deposits increased from 1963 to 1966. By 1967, Islamic finance started to grow and nine other Islamic banks started offering

various services in the country. These banks neither charged nor paid interest, and they focused mostly in trade and industry, directly or indirectly, in partnership, and shared the profits with their depositors (Siddiqi, 1988). The Nasr Social Bank, established in Egypt in 1971, was later declared an interest-free commercial bank. Additional Islamic banks that entered the market include: Philippine Amanah Bank in 1973, the Dubai Islamic Bank in 1975, the Kuwait Finance House, the Faisal Islamic Bank of Sudan, The Bahrain Islamic Bank in 1979, and the Qatar Islamic Bank in 1981 (Raquibuz and Harmon, 2001).

Islamic banking has now been established in many international markets and the majority of the Islamic institutions are working towards promoting local savings, attracting foreign investments and reducing their capital expenditures. During the past three decades, the number of Islamic Financial Institutions has increased substantially in the Middle East and North African countries and they are now expanding into Europe and as far as North America.

## **Section 2.2: Islamic Finance Concepts and Principles**

The Shariah (Islamic Law) governs every aspect of Muslim people's lives; they all have to follow the guidelines in everyday life, as well as in their economic activities. For instance, Muslims are not allowed to invest in businesses that are involved in non-halal activities such as the sale of alcohol, pork, tobacco,

gambling and/or prostitution<sup>2</sup>. In Islamic financing, speculation and uncertainty is not permitted and the term of the contract or an investment is always well defined up front, which leaves no room for any ambiguity. The Islamic economic principles are a unique concept and they offer a balance between extreme capitalism and communism. For example, individuals have the freedom to generate their own wealth, as long as it is within the established moral rules and norms set on by Shariah law or Divine guidance. The principle source of the Shariah Law is the Quran, followed by the recorded teachings and preaching's of Prophet Mohammad (PBUH), the Hadith and the Sunna.

The majority of Islamic financing is done under equity based financing where the profit and losses are shared between the financier and the entrepreneur based on the ratio of their respective capitals. The Shariah system allows Islamic institutions to adjust the value of their assets and liabilities according to any changes in the fair market value of the investment. Therefore, the loss is always shared between the financial institutions and the investors.

The most important feature of Islamic finance is that it is interest-free. Islamic finance is different from conventional finance because the interest (Riba) is prohibited in Islam: banks are not allowed to offer a fixed rate of return on

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<sup>2</sup> The Dow Jones Islamic Market Indexes and the FTSE Global Islamic Index Series, which track the performances of Shariah-compliant stocks from around the world, were created to meet the growing demand for financial products that adhere to such Islamic investment guidelines.

deposits and they are not allowed to charge interest on loans (Chong, 2007). Muslims are not allowed to take or offer Riba, however, this topic is controversial as there are many different points of views of Riba, and the interpretation varies in different languages and cultures. There are other differences between Islamic finance and conventional financial system.

For example, the emphasis and the implementation criteria are different between both types of banking (see Table 2.2).

**Table 2.2: Islamic Finance Vs Conventional Finance**

<b>Islamic Finance</b>	<b>Conventional Finance</b>
Focus on Investment	Focus on Landings
Emphasis on soundness of the project	Emphasis on ability to repay
Coordination with partners in resource mobilization	Dependence on borrowing in resource mobilization
Apply moral criteria in Investment	Apply only a financial criteria

Source: (Al Baraka Banking Group)

Another unique feature of Islamic finance is its profit-and-loss sharing (PLS) paradigm, which is predominantly based on the Mudarabah (profit-sharing) and Musharakah (joint venture) concepts of Islamic contracting. It is a common assumption that Islamic banking is zero interest rate analogy, however, based on

these principles between Islamic finance and interest based financing appears to be the cost of capital in interest-based financing, which is at a predetermined fixed rate, and in Islamic finance it is expressed as a ratio of profit.

The concept of mortgage financing in Islamic financial system is much different from conventional systems. For example, instead of loaning the necessary down payment to the potential home owner, the bank might buy the property from the seller, and then re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in instalments. In other words, the bank profit cannot be made explicit and therefore there are no additional penalties for late payments which would cause many issues in a conventional system.

### **Section 2.3: Financing on Profit Loss Sharing (PLS) Basis**

Under this method, there is a shift from debt based transactions to investment based financing. Profit Loss Sharing (PLS) dominates the theoretical literature on Islamic finance<sup>3</sup>. According to (Humayon, 2001), PLS is a contractual arrangement between two or more transacting parties, which allows them to pool their resources to invest in a project to share both profits and losses. Most Islamic economists contend that PLS is based on two major modes of financing, namely Mudaraba and Musharaka, and is desirable in an Islamic

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<sup>3</sup> The emphasis on PLS systems from the Islamic ban on interest. Many would argue that theoretical models of Islamic banking and finance exaggerate the usefulness of PLS; but still as a matter of fact PLS is the dominate mode of financing.

context wherein reward-sharing is related to risk-sharing between two parties<sup>4</sup>. There are many explanations that are defined for PLS systems. Following is an in-depth of the PLS system (Presley, (2000/01)).

- First, PLS contracts could cause the agency problems as one party could put in less effort to show or to report profit as compared to a self-financing owner or manager.
- Second, the PLS system requires well defined property rights, and people should fully understand the profit and loss system in order for this system to work more effectively. In many of the countries applying this system, people do not have a full understanding of their rights, and the rules are not well defined.
- Third, Islamic financial institutions have to provide very attractive offers in order for them to compete with the conventional banks' offers which are already established.
- Fourth, the role of management changes when an institution offers a contract on PLS basis. Sometimes, the PLS contract makes the partner non-participatory, removing it from the decision making process. In

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<sup>4</sup> Mudharaba is a limited liability contract between two or more parties in which one party provides capital to other(s) to start a joint venture to share in profits, according to a mutually agreed upon ratio. The loss, if incurs, is borne by the capital provider. Musharaka, meaning partnership.



this way, they are not sharing contracts in a true sense (Choudhury, 1998).

- Fifth, equity financing is not the most attractive way to fund the project in the short run due the high degree of risk and time diversification. In other words, there is a lack of a certain degree of liquidity<sup>5</sup>.
- Sixth, taxation could cause a huge problem in the PLS system and there could be confusion or tax evasion when profits and losses are being taxed. This could also lead to legal discrimination.

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<sup>5</sup> Alternatively, Islamic banks could maintain a large cash reserve to fund short-term projects. But this is rejected on efficiency grounds.



## **CHAPTER III**

### **REVIEW OF LITERATURE**

There is substantial and growing literature on Islamic finance (Alliance, 2010; Iqbal, 2001; Garas, 2003; Iqbal, 1998; Hassan, 2001; Sole, 2007; Tahir, 2003; Vayanos, 2008; Khan, 1992 and 1990 ; Presley, 2000/01; Siddiqui, 2000; Zaman, 2001; Samad, 2004; Ariff, 1988; Liu, 2007; Schaik, 2001; Al-Rifae, 2000; Kpodart, 2010; Hesse, 2008; Samad, 2004). The review of literature is divided into five sections. Section 3.1 deals with basic principles and concepts of Islamic finance. Section 3.2 explains the growth of Islamic banking. Section 3.3 presents a comparison between Islamic banking with western banking system. Section 3.4 discusses the challenges that Islamic finance is facing in Islamic countries. Finally, section 3.5 discusses the challenges that Islamic finance is facing in Non-Islamic countries.

#### **Section 3.1: Basic Principles and Concepts of Islamic Finance**

It is important to know the basic principles which make Islamic financing unique and attractive. According to the Shariah law, Islamic financial institutions must be based strictly on four basic principles (Samad, 2004):

- Earning and charging interest is not allowed in Islamic finance and all the transactions must be interest free.
- Islamic finance follows the concept of profit-and-loss-sharing

- Speculation (gharar) or any uncertainty is not allowed in any kind of transactions.
- The implementation of (Zakat) which is called the compulsory Islamic tax.
- Finally, there should not be any involvement in the production or consumption of goods and services which are (haram), i.e., gambling, alcohol, pork etc.

This next section will discuss the Islamic financial principles and terminologies that are commonly used in the Islamic financial institutions.

### *Riba*

In the past, the term Riba or usury always created controversy among the Muslim scholars. There now seems to be a general consensus that the term Riba includes any amount charged over and above the principal (Samad, 2004). The payment of interest or receiving of interest, which is the fundamental principle of conventional financing, is explicitly prohibited in Islamic finance. For example, Prophet Mohammad (PBUH) condemned not only those who take interest but also those who give, record, or witness, as they are all alike in guilt. Indeed, not only Islam, but also Judaism and Christianity ask their followers to shun usury to avoid hell fire (Homer, 1977). The term Riba is defined in two senses in Shariah law. First, Riba al-nasiah, which is the fixing in advance of a positive return on a loan as a reward for waiting to be repaid. Second, Riba al-fadl, is encountered in a

hand-to-hand purchase, and in sale of commodities. The Shariah prohibits both forms of Riba (Hassan, 2001).

### *Gharar*

Gharar is speculation or gambling is forbidden in Islam. Any transaction involving the element of speculation, for example, buying at a low price and selling them at a higher price in the future, is considered against the Shariah law (Samad, 2004).

### *Zakat*

This is an important aspect of Islamic finance and this is considered a compulsory religious payment or tax on the wealth of the rich and a distribution to the poor. This is also considered one of the five pillars of Islam. Every Muslim is obligated to pay Zakat on any earned income and each Islamic financial institution must establish a Zakat fund and pay Zakat on the profits earned. On the other hand, conventional financial systems are only subjected to corporate business tax, and thus have an advantage over Islamic finance (Samad, 2004).

### *Islamic Ethics*

In Islamic finance, Muslims are not permitted to invest in the production, distribution, and consumption of alcohol, pork, gambling, illegal drugs etc. Also, they are not permitted to finance these activities according to the Shariah law. These restrictions affect the profitability of the Islamic finance. On the other

hand, conventional financial institutions do not face any restrictions when financing these kinds of activities (Samad, 2004).

#### *Musyarakah (Joint Venture)*

Is similar to joint venture agreements, in which the bank and an investor jointly contribute the capital and any profit and loss from the project is shared in a predetermined manner. Unlike the case of Mudaraba (profit-sharing), the financial institutions not only participate in the supply of capital to the venture, but also in its management (Chapra, 1999).

#### *Mudarabah (Profit-Sharing)*

This concept is the profit sharing contract between the bank and an investor. The project is fully funded by the bank and the investor provides the expertise and labour. Accordingly, both parties work together to complete the project. In the case of profit, it is shared by both parties according to a predetermined (fixed) ratio. However, in the case of a loss, the bank will bear all the loss and the principal is reduced by the amount of the loss.

#### *Murabaha (Cost Plus)*

This kind of financing is based on the mark-up or cost plus principle where the bank buys an asset, (i.e., a house) for a customer and resells it back to the customer at a predetermined price, which includes the cost plus the profit

margin<sup>6</sup>. This instrument is used by the Islamic banks and consists of transactions where the institution buys a product (e.g., a car or equipment) on the client's behalf and then resells it to the client (the borrower) with a mark-up to the client (DeGelden and Khan, 1985).

### *Ijarah (Leasing)*

This is also called leasing financing. Leasing is also an important aspect of Islamic finance. The bank buys an asset for a customer and then leases it back to the client for a certain period of time at a fixed rental charge. In this case, the bank (lessor) retains the risk of asset ownership. There are two types of leases that are used in Islamic finance. First, the lessee pays the lessor an instalment payment that goes towards the ultimate purchase of the equipment by the lessee (Wohabe, 1997). This type of purchase agreement is known as *Ijara Wa-iqtina* (Martin, 1997). The second type of lease maintains the ownership of the lessor as per the lease contract (Khan, 1993).

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<sup>6</sup> Advocates of Islamic banking argue that the profit mark-up on murabaha financing is not considered as 'interest' because the profit is made on the exchange of money for goods and not money for money.

### *Istinsa (Pre-delivery)*

This is a pre-delivery financing and a leasing structured mode that is used mostly to finance long-term large-scale facilities involving the construction of a power plant. There could be legal issues relating to Istinsa, including whether or not the Islamic institution can own real property under local law, and whether the concession or other rights granted to the project company can be assumed or used by the Islamic institution (Hassan, 2001).

### *Bal' Muajjal (Credit Sale)*

This is called credit sale, where a contract has been signed between the bank and the buyer in which the bank earns a profit margin on the purchase price and allows the buyer to pay the price of the commodity at a future date, in a lump sum or by regular instalments.

### *Sukuk (Islamic Bonds)*

This is the Islamic name for financial certificates that are the equivalent of bonds; however, in Islam, interest-bearing and fixed income is not permissible. According to the Shariah Law, Sukuk are securities that comply with the Islamic principles and do not charge or pay interest (Zaman, 2001).

There is limited theoretical literature pertaining to Islamic Financial Institutions (IFIs) and how they can lead to international exposure. Zaher and Hassan (2001) provide a comparative study on the relevant features of the Islamic banking supervisory system in over fifteen countries. They explain that the lack of

regulatory framework in IFIs' countries poses a serious problem for IFIs to ensure the existence of uniform standards and policies and a proper implementation internationally. Furthermore, Aggrawal and Yousef (2000) explain the economic rationales for the superiority of the Islamic financing system compared to its conventional counterpart. Ebhrahim and Joo (2001) explain that the IFIs' internationalization process greatly depends on uniform regulators, who should develop a more advanced financial engineering system for the advancement and implementation of the Islamic banking system. IFIs need to educate international investors about the development and the growth of ethical funds and how they will add value to their portfolios (Hassan, 1999; Suseno, 2002).

#### *Takaful (Insurance Products)*

Non-mutual insurance is not permitted in Islamic finance. The concept of insurance has always been controversial in Islamic finance and the relationship between insurers and the insured does not comply with Shariah teachings, as it involves the trading of uncertainty, which is not acceptable in Shariah Law.

#### *Derivative Instruments*

Derivative contracts are important financial instruments, and are widely used by financial institutions. These are used to hedge and reduce the risks associated with certain transactions, but some conventional derivatives are controversial to Islamic finance. Despite these controversies, Islamic finance

realizes the importance of these instruments for financial institutions and there are several initiatives underway to develop these instruments further<sup>7</sup>.

### *Mark-Up Contracts*

Islamic mark-up contracts (Murabha, Ijara, Ijara Wa-Iktina, and Istinsa) are widely used, but their acceptability is widely disputed by many Islamic scholars because they would like to see these contracts still be restricted or avoided out of fear that they may open a “back door” to interest (Siddiqi, 1983). One of the main features of mark-up instruments is that the financial instruments retain ownership of the asset and can seize it in cases of default. Thus, the control rights of mark-up contracts are equivalent to the control rights of debt instruments.

## **Section 3.2: The Growth of Islamic Finance**

Islamic finance is growing at a rate of 10-15% per year with signs of consistent future growth (Martin, 2008). There are over 300 institutions all over the world in over 51 countries and they continue to grow every year. Also, there are over 250 mutual funds that comply with Islamic principles. It is estimated that over US\$822 billion worldwide Shariah-compliant assets are managed according

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<sup>7</sup> The international swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) have signed a cooperation agreement to develop Shariah-compliant derivatives.



to (The Economist, 2009)<sup>8</sup>. According to CIMB Group Holdings, Islamic finance is the fastest-growing segment of the global financial system and sales of Islamic bonds may rise by 24 percent to \$25 billion in 2010<sup>9</sup>. The Shariah-compliant assets reached about \$400 billion throughout the world in 2009, according to Standard & Poor's Ratings Services, and the potential market is \$4 trillion<sup>10</sup>.

Another reason there is significant growth in Islamic finance is the changing demographics and the overall macroeconomic growth in Muslim countries. The Muslim countries have young populations and their financial services are all increasingly sophisticated. Also, Islamic finance offers products that are not delivered by conventional systems and thus complement rather than substitute for conventional banks (Kpodar, 2010).

Traditionally, specialized Islamic finance has been well positioned to attract deposits from Muslims and non-Muslims, but these institutions have generally lacked the technical ability to invest efficiently. This trend is now changing and Islamic financial institutions are becoming more resourceful; they are going global and they have increased their integration with international markets (Hassan and Zaher, 2001). The Western banks are working closely with

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<sup>8</sup> Shariah calling". *The Economist*. 2009-11-12.

<sup>9</sup> <http://www.iran-daily.com/1388/12/11/MainPaper/3630/Page/5/Index.htm>

<sup>10</sup> <http://iran-daily.com/1386/2860/html/focus.htm>

the investors directly and eliminating the middleman (the Islamic banks or Islamic windows of banks) in Muslim countries (Hassan, 2001).

Another important factor that contributed to the growth of the Islamic financial institutions was the economical growth of Gulf Corporation Council (GCC) as a result of oil discovery and the establishment of the Organization of Petroleum Exporting Countries (OPEC) (Moore, 1997). This unexpected growth changed the lifestyle of the whole region and provided a very solid foundation for Islamic financial institutions. Islamic finance has grown fairly fast but after the tragedy of September 11, Arab investors have preferred to hold most of their investments in the Middle East in case another similar event occurs. This move made the Islamic financial system very strong during the world financial slump and investors gained confidence about the growth of their investments.

On the other hand, investor's confidence was shaken around the world in the non-Muslim countries. Furthermore, the central banks in the Gulf Corporation Council countries urged the Accounting and auditing Organizations for Islamic Financial Institutions (AAOIFI) to setup uniform accounting and auditing standards for Islamic financial institutions to protect these investments and better position themselves against their competitors.

### **Section 3.3: Islamic Banks vs. Conventional Banks**

Islamic finance has been growing worldwide and it is important to compare the financial parameters of Islamic banks and conventional banks (see

Table 3a & b). Loghod (2006) has evaluated differences in financial parameters of Islamic banks and conventional banks in the Gulf Cooperation Council Countries (GCC) during 2000-05. The GCC have a dual banking system where Islamic and conventional banks are operating side by side and the purpose of this section is to compare the financial performance.

**Table 3a: Selected Financial Ratios – Islamic Vs Conventional Banks**

<b>Financial parameters</b>	<b>Bank Type</b>	<b>Mean</b>	<b>Standard Deviation</b>
Return on Assts	Conventional Banks	2.27	2.08
	Islamic Banks	2.07	1.52
Return On Equity	Conventional Banks	14.12	11.13
	Islamic Banks	13.99	10.00
Dividend Payout	Conventional Banks	46.11	28.59
	Islamic Banks	45.01	31.94
Cash to Assets	Conventional Banks	4.87	3.29
	Islamic Banks	10.14	8.35
Cash on Deposits	Conventional Banks	6.83	7.25
	Islamic Banks	15.46	13.41
Debt to Assets	Conventional Banks	84.58	6.61
	Islamic Banks	83.21	8.25

Source: Loghod (2006). For further details, see, [www.islamic-finance.net](http://www.islamic-finance.net)

As may be seen in Table 3a, the conventional banks have a relatively higher profitability (as revealed by Return on Assets and Return on Equity)

compared with Islamic banks. But the variability of profit ratio as revealed by standard deviation is lower in the case of Islamic banks. The dividend pay-out ratio was again higher in conventional banks but the variability of dividend payout ratio was relatively lower in Islamic banks. The lower variability of Islamic banks' financial performance indicator is a distinguishing feature, which implies that they are relatively more stable than conventional banks. As far as liquidity is also concerned (cash to assets/deposits), Islamic banks compare favourably to conventional banks.

**Table 3b: Selected Financial Ratios – Islamic Vs Conventional Banks**

<b>Financial parameters</b>	<b>Bank Type</b>	<b>Mean</b>	<b>Standard Deviation</b>
Loans to Assets	Conventional Banks	49.95	16.00
	Islamic Banks	72.55	15.34
Loans to Deposits	Conventional Banks	16.93	35.56
	Islamic Banks	104.71	36.24
Loans to Equity	Conventional Banks	371.77	158.64
	Islamic Banks	558.62	296.18
Deposits to Assets	Conventional Banks	76.55	13.37
	Islamic Banks	62.74	27.71

Source: Same as table 3a.

As far as operations, loans to asset, loans to deposits, and loans to equity ratios are concerned, Islamic banks have higher ratios, which implies that they are

able to leverage their resources (deposit/assets/equity) better than conventional banks (Table 3b).

### **Section 3.4: Challenges for Islamic Finance in Islamic Countries**

Islamic finance has quickly established itself in several markets, but the majority of the potential customers still do not clearly understand the unique concept of Islamic finance and how it is different from conventional finance.

Islamic finance offers unique characteristics which give rise to a set of challenges that Islamic banking has been facing (Garas, 2003).

Among these challenges:

- The risk and liquidity management techniques,
- Islamic finance faces the inconsistency of implementing the Shariah law and supervision,
- Training and retaining talented employees
- There are many legal and tax restrictions that create inconsistency and confusion.

Islamic financial institutions need to evaluate their risk and compliance techniques to ensure they are mitigating their risks and are fully compliant with the Shariah financial systems. There is a need for risk analysis and risk-management studies to provide better understanding of financial instruments. The prohibition of interest performed an important role when managing liquidity,

pricing risk and allocating credit. Therefore, Islamic institutions are required to hold higher levels of liquidity compared to the conventional institutions in order to compete against the conventional financial banking system.

Another challenge Islamic finance is facing is that it does not have a strong foundation of short-term liquidity management and long-term refinancing instruments. This challenge is causing higher asset liability management. Islamic finance needs to encourage the development of appropriate Shariah-compliant standards and provide universal standards. Also, the regulatory framework needs to be standardized with one interpretation for all the Islamic principles.

Furthermore, another major challenge that Islamic finance is facing is that Islamic banks are not able to fulfill all senior level positions with the limited available talent pool. Given the way Islamic finance is growing, there is not enough skilled manpower available in the marketplace to fulfil the positions. It takes many years to learn about Shariah laws and become a scholar, and at this time there are not enough scholars available to sit on multiple boards. Furthermore, there are still considerable disagreements among scholars as to which institutions and instruments are religiously acceptable. For example, in some countries, the legal structure does not allow real Islamic business practices such as trading or leasing as they are not fully compliant with the Shariah Law.

Islamic finance is also facing the huge challenge of legal and taxation, which makes Islamic finance difficult to compete to the conventional financial system. In Islamic finance, Zakat is treated as non-operating expense in Islamic

financial statements and consequently has no effect on net income (Ahmad, 2002). On the other hand, once the Zakat has been collected, the Islamic institutions are required to pay regulatory fees, which results in double payments to meet the dual regulations of Islamic and conventional system.

Islamic finance also faces regulatory concerns over licensing. Many Islamic banks have not yet been able to fully adapt accounting and control systems, which makes it very difficult for the regulators to determine banks' internal health and the soundness. The regulators' limited influence over Islamic financial institutions' activities and transaction in most of the Organization of Islamic Countries leads to investors' limited recognition (Garas, 2003). Also, the central banks do not have an effective role in regulating the standards and practices for the Islamic financial institutions and that creates inconsistent accounting practices and inadequate disclosure in financial statements.

Another significant challenge is to keep pace with investor demand for new and innovative products. Every project has to go through an evaluation process by its Shariah council and they may have different interpretations of Islamic finance, which may lead to delays or create more controversy when approving these projects.

Despite all its growth, Islamic finance is still facing many limitations, which makes investors reluctant to invest in Islamic financial products in the same way they trust conventional finance. Most countries are still obligated to follow

their local financial institutions and that obligations sometimes conflicts with the Financial Accounting Standards Board and IFRS mandate.

### **Section 3.5: Challenges outside the Islamic Countries**

Islamic finance is facing many challenges outside of the Islamic countries. The western financial systems are reluctant to accommodate any changes from the Organization of Islamic Countries (OIC) that might enhance the political power of the OIC. Also, differences in cultures, languages and religions create additional barriers between Islamic finance and its growth towards globalization (Garas, 2003).

***Cultural barrier:*** there is a huge tangible challenge between Muslims and the non-Muslim world. This cultural gap has been widening due to the media and some terrorists attacks that negatively impacted the image of Islam. The Islamic financial institutions need to have an open dialogue by arranging more conferences, seminars and other means of communications to find common grounds to shorten these gaps. Furthermore, the Islamic financial institutions should try to study the conventional financial offerings and try to find ways to invest in products that are compliant with the Islamic Shariah. This kind of change will open more doors of opportunity for both sides, and it will encourage both sides to work closer and change the negative stereotyping of IFIs.

***Limited recognition:*** Globally, Islamic finance is not fully recognized by their central banks. In the Islamic countries, Islamic finance is very much



dependent on the political system. The financial institutions are strongly influenced by the political system and they steer certain capitals towards certain industries through reserve requirements. This lack of standardization creates confusion when the IFIs try to implement the same strategy on the global level, and sometimes it does not get approval from other countries (George, 2004).

***Size:*** Another challenge IFIs face is their size. There are many smaller financial institutions that are only inside the Muslim countries, and most of them are acquired by the bigger banks as the banks are always looking to expand. One of the areas where these IFIs can be very successful, especially in banking, is as specialized banks in their geographical areas. For example, in Africa the focus might be on agriculture, in Asia, the banks can focus on industrial and service sectors, and in Europe & North America, the focus could be on Capital and financial leasing (Hassan, 2001).

***Secondary market:*** Another challenge IFIs face is a shallow secondary market. Also, the interbank market is essentially nonexistent and the financial institutions have been offering the same traditional financial instruments for the last few decades. The lack of liquidity-enhancing instruments has eliminated a large segment of potential investors (Hassan, 2001).

## **CHAPTER IV**

### **DATA BASE AND METHODOLOGY**

In order to examine the relevance of Islamic finance in the Canadian context, we adopt the ‘case study’ approach<sup>11</sup>. Using the case study approach, we intend to elucidate the unique relevance<sup>12</sup> of Islamic finance in western countries like Canada.

As part of the case study, we make a comparative study of two fields in the area of finance: (a) mutual funds and (b) development finance (microfinance). In this approach, we compare the financial and non-financial metrics of an Islamic mutual fund with that of a market based mutual fund widely available in the western market place. Similarly, we also compare the financial and non financial matrices of an Islamic microfinance program with that of a traditional microfinance program (in the spirit of Bangladesh’s Grameen Bank). There are not enough empirical studies on the Islamic banking as it is a new concept and there are many different variations in practices of reporting and disclosing this information. Sometimes, the interpretation is different when attempting to reconcile the data and put together a comparable series.

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<sup>11</sup> For details see, Bryman and Bell (2007).

<sup>12</sup> In literature, this is known as idiographic approach as opposed to nomothetic approach. See Bryman and Bell (2007), p. 63.

We undertake an analysis of Islamic mutual funds as compared with the performance of conventional mutual funds in Chapter VI. In Chapter VII, we evaluate the performance of the Islamic development finance institution (Aga Khan Development Network), which operates in 25 countries and where the Canadian government (Canadian International Development Agency) is an active participant.

## **CHAPTER V**

### **ISLAMIC FINANCE AND WESTERN FINANCIAL SYSTEM**

The Islamic financial industry has experienced a growth rate of 10 to 15 percent per annum. This follows a trend and the growing demand by the Muslim population in the Western countries to geographically diversify their portfolio. The conventional financial systems are increasingly becoming interested in entering the market of Islamic financial products. When establishing Islamic finance in the Western countries, first the financial institutions need to decide if they are going to establish an Islamic subsidiary or fully convert into a fully fledged Islamic financial institution. There are benefits either way for the banks, as they will be enjoying economies of scope. The advantage of opening a subsidiary over a full conversion bank is that the bank is able to offer, under one roof, a wider range of Shariah compliant financial products as well as convention financial products. On the other hand, if the financial institution decides to fully convert to an Islamic financial institution, this will signal that the financial institution is fully committed to operate under the Shariah principles, which will enhance its credibility.

The issue these conventional financial institutions are facing that they are not fully aware of the requirements or principles that are governing Islamic finance. The lack of knowledge will continue to be a big challenge for the conventional financial institution as the conventional banks are only aware of well known principles such as Riba (interest) Gharar and Maisir (contractual

uncertainty and gambling), and haram industries (prohibited industries such as those related to pork, alcohol, pornography), but there are other principles that are very crucial and need to be fully understood in order for institutions to comply with Shariah jurisdiction. Having a good understanding of Shariah law is the key to success for the Islamic financial system in the western countries.

There are four areas that are very important in order for Islamic finance to be successfully introduced into a conventional banking system in the western countries (Yaquby, 2005).

- Full compliance with the Shariah law
- The segregation of Islamic and conventional funds
- Accounting standards, and
- General public awareness campaigns

Islamic finance fully revolves around the Shariah Law and other rulings, known as fatwa, issued by qualified Muslim scholars. Some of the issues or rulings are fairly complex and the assistance of experts on both sides is required to understand and implement them. Finding an expert scholar on both sides in each country is still relatively difficult and sometimes these scholars are on multiple boards, which makes it challenging to promote consistency across the board. Also, there could be an issue of conflict of interest. Therefore, the first step should be to appoint a Shariah board which will ensure that all the products and services are fully compliant with Shariah law, and they will deal with any disagreements or conflicts, and will help minimize Shariah risk. Furthermore,

each financial institution should setup financial regulators to provide advice on the instruments and services offered by the institutions in their jurisdiction. These regulators can work as consultants to ensure that the licensing of different activities is fully compatible with the Islamic principles Shariah supervisory board.

### **Section 5.1: Islamic Finance in Canada**

In Canada, Shariah based financing is available, but on a limited basis. As Islamic finance is continued to grow, there are vast opportunities for the Islamic financial institutions to expand their financial products, advice, and services in Canada. One of the key drivers for Islamic finance in Canada has been the immigration of Muslims into this country. In Canada, there are few private institutions that are offering Shariah compliant product and services, but the major big banks have so far avoided the market and they do not have a full regulatory framework to tap into this unique market.

Islamic finance is facing the same challenges in Canada as what the facing in the other parts of the world. Lack of knowledge around Shariah-compliance is the biggest challenge the financial institutions are facing in Canada. Royal Bank of Canada ventured into this market by testing a Shariah compliant financing products few years ago, but the bank experienced a lack of demand and decided to

not pursue any further at that time<sup>13</sup>. Now, the market trends are changing and most of the financial institutions are looking into incorporating Islamic finance into their financial system. The financial institutions have started looking into some basic retail banking packages such as chequing, savings, safety deposit boxes, and credit cards. The financial institutions should work closely with the smaller financial institutions and this will give them better exposure to the smaller communities in the various parts of Canada.

There are recent announcements and developments that reflect the growing interest of Islamic finance in Canadian financial system. The representatives from each group are getting together to discuss and accommodate Islamic financial needs and how it can incorporate with the Islamic commercial law compliant products<sup>14</sup>. The Canada Mortgage and Housing Corporation (CMHC) is actively working to implement Islamic commercial law compliant mortgages. Finally, there are reports that a number of applications are under the review with the Office of the Superintendent of Financial Institutions of Canada (OSFI) to seek permission to establish and grow Islamic financial system in Canada<sup>15</sup>.

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<sup>13</sup> WWW.REPORTSONBUSINESS.COM

<sup>14</sup> Toronto Financial Services Alliance – Islamic Finance Working group: [www.tfsa.ca](http://www.tfsa.ca)

<sup>15</sup> [www.tfsa.ca](http://www.tfsa.ca)

Looking forward, there is definitely a scope for Islamic banking in Canada and the services can be expended to non-Muslims, as well as Muslims. The key is to have good understanding about the Shariah Law and how the product development can be a niche product for the conventional financial system. One of the challenges Islamic banks will be facing in Canada is how to deal with the Tax Free Savings Account (TFSA) and will this product grow in the Islamic financial system? Also, there is a lot of work that needs to be done in the Canadian tax and commercial legislation system to adapt all these new Shariah-compliant product and services. This will be a very challenging task and it will take some time to eliminate the uncertainty and unpredictability with respect to some key issues that need to be addressed.



## **CHAPTER VI**

### **MUTUAL FUND – A COMPARATIVE STUDY OF ISLAMIC AND WESTERN MUTUAL FUNDS**

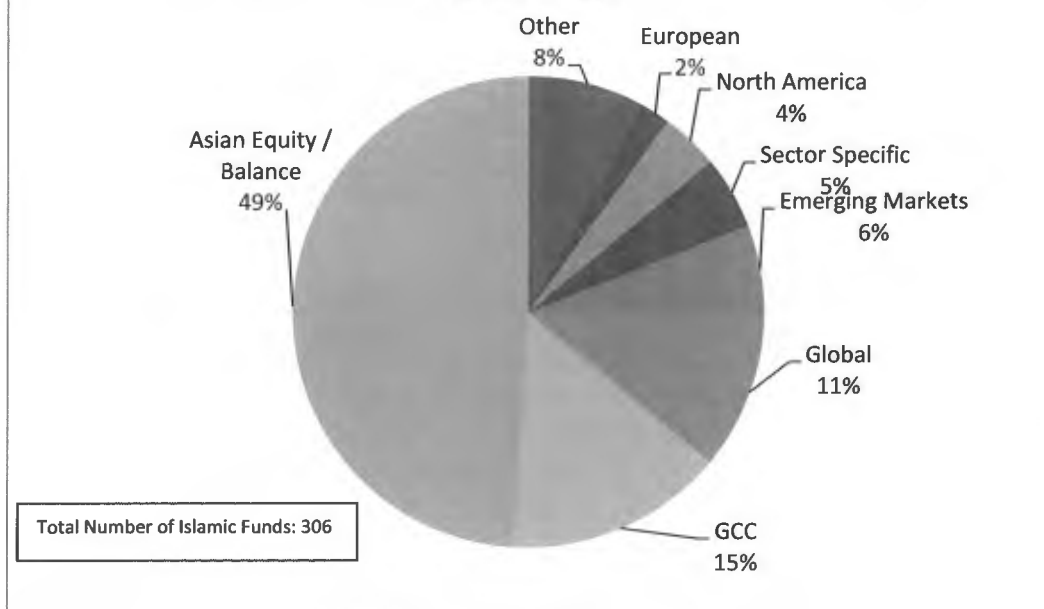
The Islamic investment equity funds market is one of the fastest growing sectors within the Islamic financial system. These funds should be fully compatible with the Shariah Law and should not be mixed with non-Islamic investments. The development of sukuk (Islamic bonds) has revolutionized Islamic finance in recent year. Currently, there are approximately over 608 Islamic equity funds that are being traded worldwide. The growth of these funds is around 12 to 15% per year and the estimated value of these assets is approximately over \$5 billion (Ariff, 1998 and Eureka hedge pte ltd. 2008).

According to the Dow Jones and Company Inc. study in 2007, the Islamic funds are heavily focus on the equity funds and the fund distribution is as follows globally<sup>16</sup> (see Figure 6.1).

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<sup>16</sup> Failaka – 2007 Dow Jones and Company, Inc.

**Figure 6.1: Islamic Equity Fund Universe by Asset Class**



Source: Failaka – Dow Jones Indexes: 2007 Dow Jones and company, Inc.

The strong growth has attracted many other institutions to start offering Islamic funds. Despite their success, the Islamic funds still have not been able to perform up to their potential and the poor marketing for some of these funds has created confusion and uncertainty in the potential investor's mind. Also, global exposure was missing when these funds were launched, and the focus for these funds was more catered toward local markets: for example, Malaysia and Gulf-based investment funds, and Middle East and Gulf regions funds.

Islamic funds need to be fully compliant with Islamic principles and conventional banks need to guarantee and publicized that these funds are fully devoted to Islamic finance and that they are not commingled with the non-Islamic investments.

The rate of return on assets for Islamic finance is comparable to the corresponding rates for the commercial finance. However, the deposits of Islamic banks are not guaranteed, unlike conventional banks. Therefore, the investor would expect to have a higher rate of return for Islamic funds. The encouraging thing is that the asset ratio for Islamic funds as a group is well above the international standards and the average rate of return on capital for Islamic funds is also quite favourable, compared to the conventional financial system.

The mutual fund comparative study chapter is divided into three sections. Section 6.1 deals with the six mutual funds pillars that are important for the Islamic mutual funds. Section 6.2 explains the family of Dow Jones Islamic indexes that are performing exceptionally well in the Islamic market. Section 6.3 presents a comparison between Islamic and conventional mutual funds.

### **Section 6.1: Islamic Mutual Funds Pillars**

Islamic mutual funds consist of six main pillars that make these mutual funds very competitive and successful (Hassan, 2001).

- ***Shariah Supervision*** – the supervisory board is responsible for the Islamic equity funds structure and consists of well-known scholars that are very well versed and experienced in the Shariah laws.
- ***Screening*** – this is to ensure that trading securities and investment portfolios are based on the religious and ethical standards of the Islamic Shariah. This is the most crucial part of the securities as to

exclude such non-Shariah companies that receives their major portion of their revenues from alcohol, tobacco, or interest based financial institutions such as banks, brokerage, and insurance companies.

- ***Purification*** – this is the process of eliminating portfolios that result from interest (Riba) sources.
- ***Zakat / Charity*** – Zakat is given to the charities and non-profit organizations. There are many ways of calculating the percentage of zakat and sometimes the tax deferred or exempt arrangements makes this calculation complicated.
- ***Monitoring & Reporting*** – the funds strategies and policies should be properly screened and regularly monitored, and the scholars should provide diligent analysis of the company financial statements and practices.
- ***Community-Based Investment*** – there should be community based programs that provide assistance to the low-income housing and small business development to enable people to improve their standard of living and establish their community presence (Valpy, 2000).

## Section 6.2: Dow Jones Islamic Index

Dow Jones Indexes has created a family of Islamic equity funds that invest according to Islamic investment guidelines (Hassan, 2001). Now there are many other financial institutions that are offering Islamic equity funds. The Dow Jones Islamic Market Indexes track Shariah Law compliant stocks from around the world. Currently, some of the indexes that have been included are DJ Islamic Market Index (DJIM), S&P 500, the DJ Islamic Market US Index (IMUS), the DJ Islamic Market Technology Index (IMTEC), the DJ Islamic Market Canadian Index (IMCAN), and the DJ Islamic Market Asia / Pacific Index (IMAP) (Hassan, 2001). The performances of these indexes are compared in the following charts (See Figures 6.2, 6.3, 6.4, 6.5).

**Figure 6.2: S&P/TSX composite Index**



Source: Google Finance Canada. [www.google.ca/finance](http://www.google.ca/finance)

## Figure 6.3: Dow Jones Industrial Average



Source: Google Finance Canada. [www.google.ca/finance](http://www.google.ca/finance)

## Figure 6.4: S&P 500 Index, RTH



Source: Google Finance Canada. [www.google.ca/finance](http://www.google.ca/finance)

**Figure 6.5: Dow Jones Islamic Market World Index.**



Source: Google Finance Canada. [www.google.ca/finance](http://www.google.ca/finance)

### Section 6.3: Comparison between Islamic and Conventional Mutual Funds

With worldwide, Islamic equity funds have been launched around the globe and are operating in compliance with the ethical guidelines of the Islamic Law. The first biggest difference between Islamic and conventional funds is the asset class mix. Even these funds are classified around the same level across the different regions (Table 6.6). The asset class for the equity class is around 41% to 55% in all the regions, which is not much different from the conventional funds. Another interesting thing to note is there is high concentration of the European

and North American funds under the “Other” category, and they are focused on the private real estate and private equity funds.

**Table 6.6: Global Asset Class Mix Funds**

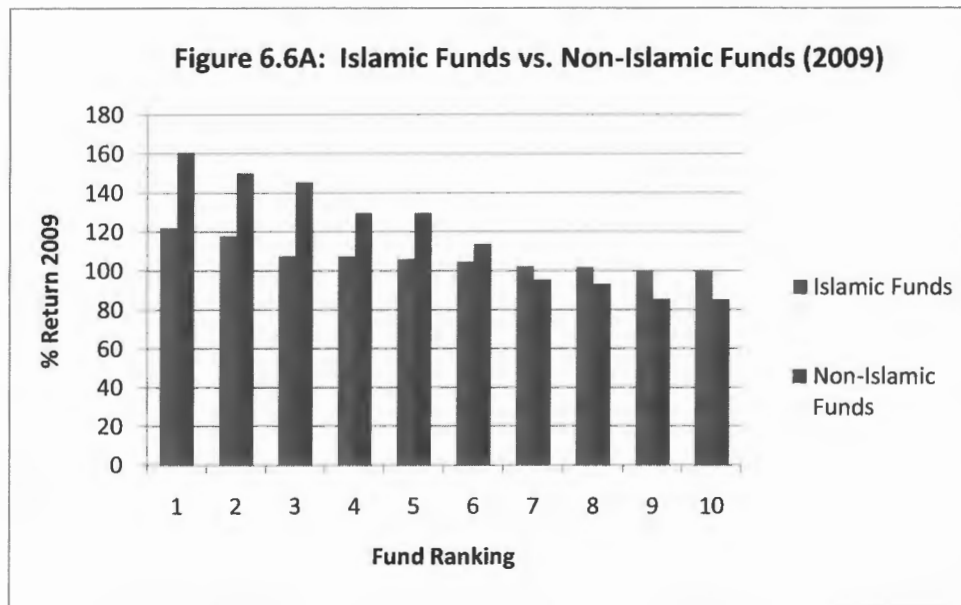
<b>Classification</b>	<b>Asia Pacific</b>	<b>Europe</b>	<b>Global</b>	<b>Middle East/Africa</b>	<b>North America</b>	<b>Total</b>	<b>Conventional</b>
<b>Equity</b>	52%	46%	55%	51%	41%	51%	42%
<b>Fixed Income</b>	14%	0%	2%	4%	0%	6%	22%
<b>Balanced</b>	16%	4%	6%	6%	0%	8%	20%
<b>Money Market</b>	11%	0%	21%	13%	2%	13%	6%
<b>Others</b>	8%	50%	16%	26%	57%	21%	10%
<b>* - within 10% boundary</b>							

Source: Eurekahedge, Investment Company Institute (ICI)

There are many aspects that have differentiated the Islamic funds from the conventional funds. One such aspect is the fee structure and management expense ratio (MER): Islamic funds are also called passive funds and the average annual management expense ratio for the Islamic funds is significantly less than the conventional funds. When selecting an investment funds, the conventional funds can freely chose between debt-bearing and profit-bearing investments. However, Islamic mutual fund must select those companies that meet its qualitative and quantitative criteria set by Shariah guidelines.

The performance between both Islamic and conventional funds is very similar and it depends on which market these funds have been offered. There is a comparison of top 10 Islamic and conventional funds in 2009 (figure 6.6A).





Source: EurekaHedge - <http://www.eurekahedge.com/> & [www.morningstar.com](http://www.morningstar.com)

The annual return percentage for both Islamic and conventional funds is very similar for one year in particular. We have to make some assumptions when we are comparing these top 10 funds as it is not determined which industry these funds have been offered in and how many companies are in each fund. After making these assumptions, we can see that the annual return of these top funds are not consistently outperforming each other and it depends on which year these funds have been launched and it has much to do with the overall industry growth. The performance of these funds has increased as the performance matrices validate the initial investment decision.

Finally, table 6.7 provides us the individual Islamic and conventional funds return during the year 2009. These funds have performed exceptionally well within 2009 and it shows a comparison between the top 10 funds. There is no direct comparison between both Islamic and Conventional funds as they are

performed in different industries and in different regions. This comparison shows the potential of both Islamic and conventional funds in their perspective markets and it provides many options for potential investors.

**Table 6.7: Top 10 Islamic and Conventional Funds in 2009**

<b>Rank</b>	<b>Funds Name</b>	<b>Islamic Funds</b>
1	SI Dana Saham Syariah	122.07
2	ETFS Physical Palladium	118.00
3	Syariah Fortis Pesona Amanah	107.54
4	Meezan Islamic	107.44
5	Al Fursan	106.11
6	AL Meezan Mutual	104.66
7	Atlas Pension Islamic	102.27
8	Manulife dana Ekuitas Syariah	101.85
9	Atlas Islamic Stock	99.77
10	Taurus Ethical B	99.40
<b>Rank</b>	<b>Funds Name</b>	<b>Conventional Funds</b>
1	AlphaNorth Partners Fund	160.9
2	Redwood Global Small Cap	150.3
3	Sentry Mining Opportunities	145.6
4	Front Street Growth Series B	129.9
5	Front Street Growth Series A	129.9
6	Sprott Gold and Precious Minerals	113.8
7	Mac Universal World Prec Metal CI U\$	95.3
8	Mac Universal World Prec Metal U\$	93.3
9	Sentry Prec Metals Growth CI Ser. A	85.5
10	Sentry Prec Metals Growth	85.4

Source: EurekaHedge - <http://www.eurekaHedge.com/> & [www.morningstar.com](http://www.morningstar.com)

In conclusion, the conventional investors can consider Islamic mutual funds in their portfolio, especially during the slow market periods and have some diversification in their portfolio collection. However, the onus is on the investor, who can make a wise decision based on the performance of the fund regardless of whether it is conventional or Islamic.

## **CHAPTER VII**

### **AGA KHAN FUND FOR ECONOMIC DEVELOPMENT (AKFED)**

The Aga Khan Fund for Economic Development Network is working in over 25 countries around the world and they are dedicated to improving living conditions and providing opportunities, food and shelters for the poor, without regard to their faith, origin or gender. This network focuses on health, education, culture, and rural development, and their goal is to promote economic development. There are approximately 60,000 people employed by these agencies around the world and the majority of them are based in developing countries. The annual budget for non-profit development activities in 2008 was approximately \$450 million and these projects generated annual revenue of approximately \$1.5 billion. This chapter is divided into two sections. Section 7.1 discusses the Aga Khan development agencies that are working around the world to promote economic development. Section 7.2 explains the major industries where Aga Khan Development network is currently working.

#### **Section 7.1: Aga Khan Development Agencies**

There are many agencies that have their own mandate (see table 7.1), but they all work towards the common goal of helping the poor achieve a level of self-reliance whereby they are able to plan their own livelihoods and help those even more needy than themselves.

**Table 7.1: Aga Khan Development Network**

Aga Khan Agency for Microfinance (AKAM)	Aga Khan Education Services (AKES)
Aga Khan Foundation (AKF)	Aga Khan Fund for Economic Development (AKFED)
Aga Khan Health Services (AKHS)	Aga Khan Planning and Building Services (AKPBS)
Aga Khan Trust for Culture (AKTC)	Aga Khan University (AKU)
Focus Humanitarian Assistance (FOCUS)	The University of Central Asia (UCA)

Source: [www.akdn.org](http://www.akdn.org)

Currently, the funds network is actively working in over 16 countries on 90 separate projects. These funds companies often work in collaboration with local and international development partners to create new companies which can provide goods and services essential to economic development. Also, these funds companies work with the governments to help promote the creation of enabling legal and fiscal structures that encourage the growth of the private sector. These industries include banking, power generation, tourism, manufacturing and the agriculture sector.

## **Section 7.2: Aga Khan Major Industries**

Aga Khan Fund for Economic Development takes a long term view and here are some detailed analyses about the major industries:

***Financial Services*** – AKFED provides a strong capital market for the banks, insurance groups, and private sector in eastern Africa, Central Asia and South Asia. Most of their investments include a controlling interest in the private banks and through a government privatization program.

***Tourism Development*** – AKFED introduced Tourism Promotion Services (TPS), which developed a tourism potential in selected areas, particularly in the underserved regions. Under this program, the agency rehabilitates and manages hotels and lodges that contribute to economic growth by promoting tourism and creating jobs for the locals.

***Industrial Promotion Services (IPS)*** – AKFED works with the government, corporations, and international investors to create infrastructure needs for pressing local industries. These agencies play a vital role in the local economy and provide venture capital, technical assistance and management support to encourage their local industries.

***Microfinance & Micro-insurance*** – AKFED also started offering programs to small communities in the form of small savings and microcredit loans. The intent of these loans is to protect poor people from the effects of natural disasters and economic hardships. Also, these programs are being offered to prevent poverty, and are looking at ways to improve quality of life.

## **CHAPTER VIII**

### **FUTURE OF ISLAMIC FINANCE**

The future of Islamic finance has been established in many parts of the world, but the question is: will it survive in the long run? The survival of Islamic finance depends on the following factors (Tahir, 2003):

- The economic viability of Islamic finance
- The stability of Islamic finance in the various systems
- How Islamic finance can respond to the challenges that are mentioned above
- How Islamic finance can gain the client confidence

There will always be discussion between Islamic finance and conventional finance about the prohibition of Riba. For the conventional institutions, the option on prohibition of Riba is not economically feasible and, economically, interest is the back bone of the success of any financial institution. Dr. Tariqullah Khan (of the IDB) has stated

“A banking system would be unstable if it concentrates asset risks on bank capital. Since Islamic banking principle is based on risk sharing and it spreads risks between bank depositors and bank capital, it is inherently more stable. If this inherent quality is coupled with prudential regulations and supervision and with implementation of internationally with prudential regulations and supervision and with implementation of internationally acceptable standards of risk management,

transparency and corporate governance, Islamic banking can practically become an ideal alternative to the traditional banking system in achieving equity, stability and efficiency” (Tahir, 2003).

Finally, client confidence is the key to success for Islamic finance or as it is also called, ethical financing. Islamic finance must follow all the Shariah guidelines to ensure that the bank has not violated the Shariah mandate. This is a very sensitive issue and even a little mistake could lead to losing client confidence, and clients can withdraw their deposits which might jeopardize the whole financial system.

### ***Standardization & Financial Innovation***

Islamic finance cannot be successful without standardization. Once the Islamic financial institutions are competing at the global level, the financial products and services need to be standardized. In some cases, there are some adjustments that need to be made to ensure that some fundamental Shariah principles are followed and properly implemented. Islamic financial institutions need to use innovative ways in certain areas in order for them to grow in other non-Muslim countries. First, they need to come up with a Shariah compliant system, which will guide them in the case of penalty on default payments, and there should be adequate coverage on the deposits such as CDIC in the western banking system.



As Islamic financial institutions are gaining ground, they will be facing some new challenges and the banks need to be creative and adaptive to all the new changes. For example, there is a whole new area of international trade and accommodating Shariah compliant foreign trade financing. There should be effective corporate governance when dealing with financial institutions at different levels and there should be consultative working groups between the regulatory body and representatives of the Islamic financial community.

In sum, the regulatory authorities should strive to ensure that Islamic principles are well-understood and that there is no further confusion about Shariah laws. All transactions should fall under the guidelines of Shariah Law and all the Islamic financial customers should be offered same level regulatory protection as those of conventional financial system.

***Shari`ah Aspects:***

It is very important that every new product or innovation has to be cleared by the Shariah scholars before it is implemented in the financial system. Once it is approved by the Shariah scholars, it has to be approved by the Shariah auditing and operations side to ensure that it is fully compliant with the Shariah requirements. This process gives clients confidence and better understanding about their portfolios.

### ***Research & Development, Teaching, Training:***

Research and development is the most vital part of the Islamic finance. As it was mentioned earlier, there is shortage of scholars and most of the managers are not very knowledgeable or well trained about the use of Islamic modes of finance. The Islamic financial institutions need to put effort into development and training to ensure that the right level of skills are developed and ensure that these resources are available worldwide.

### ***Legal Framework, Policies & Procedures:***

It is very important to put in place legal frameworks and common practices for Islamic finance that are consistent from one country to another. Also, Islamic and non-Islamic institutions should be under the supervision of the central bank of the country. This deposit policy with the central banks needs to be evaluated as the central banks usually pay interest on these deposits, which is not allowed in the Islamic banking. Also, Islamic banks cannot participate in an open market operation because of the interest-based nature of the securities bought and sold. The central bank cannot offer the same controls, conditions, and regulations to Islamic banks as to conventional banks. Therefore, Islamic banks need to be treated at a different level as their requirements and needs are different compared to the conventional banking system.

## **Section 8.1: Proposed Solutions**

***Internally:*** The members of the Organization of Islamic Countries need to work together to provide support to the both primary and secondary markets and there should be one standardized framework that can be implemented globally. The focus should be on promoting Islamic finance through different channels such as issuance of stocks, attracting individual and institutional savings, and potential projects. This promotion will encourage investors to have a better understanding of Islamic banking products and services and how Islamic finance can improve their investment portfolio.

Islamic financial institutions are competing in a very tough competitive environment and they have to be innovative in their product and services to make their name in the global financial market. Islamic financial institutions need to improve their inter-bank transactions such as overnight funds and other short-term borrowing. They cannot use the same method as conventional banking given that the interest rate is embedded in the inter-bank transactions, which is forbidden in the Shariah Law.

***Externally:*** Despite all the cultural, religious, and traditional barriers, there should be better communication between the Islamic institutions and the conventional institutions. The banks should focus on integration rather than on conflicts and disagreements. Effective communication will help both sides to create more understanding and they should be more open minded to adapt new practices when they work together in the international market. Islamic financial

institutions should standardize their accounting requisites that can be applicable in all countries, and they should establish a unified framework to standardize practices in order to be recognized globally, such as the Generally Accepted Accounting Principles (GAAP), which cover all standards of auditing, accounting and financial products in a systematic way (Moore, 1997).

Islamic financial institutions should strive towards having internationally recognized rating agencies such as S&P 500, Moody's, and IBCA. Currently, Islamic financial institutions have their own ratings agency based out in Bahrain, which are self-defeating if they are trying to make their name in the emerging international market. There are already some positive developments in the market: Standard & Poor's established a new section for S&P Shariah Indices and Dow Jones also has established the Dow Jones Islamic Fund, which is getting recognized worldwide.

Furthermore, there is much needed research that needs to be done on the securitization of assets and strengthening of the recovery or payment system. Also, research and development should be done with the supervision of Shariah experts under the guidance of the Organization of Islamic Conferences (OIC) and the Accounting and Auditing Organizations of Islamic financial institutions (AAOIFI). The products and services should be well defined, and standards and risk management tools should be used to hedge against high volatility in all the Islamic financial markets. On the investment side, there should be a mechanism that coordinates with conventional institutions and provides a guarantee against

exchange rate fluctuations that could create a lot of uncertainty for the potential investors.

There should be legitimate modes established for the domestic and foreign markets. These modes should offer diversified investments portfolios and instruments that generate maximum profit with the required liquidity. The acceptability of these portfolios is much more important compared to conventional banks. The Islamic banks need to be more engaged when they are involved in the Ijarah-based financing, which requires Islamic banks to purchase and maintain the assets and afterwards dispose of them according to Shariah rules. Islamic financial institutions have great potential to expand their production capacity and self-employment opportunities in developing countries.

## **CHAPTER IX**

### **CONCLUSION AND RECOMMENDATIONS**

Islamic finance is growing very rapidly around the world requiring careful planning and having a very clear understanding of Islamic finance. Despite all the growth in the last few years, there are still supervisory authorities that are unfamiliar with the process of Islamic finance and how it is different from the conventional financial system. As Islamic finance keeps growing, the supervisory authorities will have to ensure that these new institutions become fully integrated with the rest of the financial system as well as provide a comprehensive regulatory framework and develop a supportive financial infrastructure. Islamic finance should consider having diversity in terms of their range of financial activities and in terms of reaching geographically to various parts of the world.

It is important to pay attention to the local culture and the business environments in Muslim countries. The Islamic corporate governance system is not as openly acceptable in the West as it is in the Middle East and other Muslim countries. Nevertheless, financial developments, and higher usage of equity funding in the West, have important implications for Islamic finance.

There are key requirements that need to be in place to establish the differentiated Islamic financial products:

- There should be a market intelligence that will focus on modifying the products according to the client's need.

- There should be a mechanism in place for a “Shariah board,” which will focus on the approval issues for any proposed product or services.
- There should be monitoring or compliance tolls that ensure all the products or services are fully compliant and the rulings are in accordance of the Shariah Law.
- There should be more cooperation among Muslim financial institutions and they should all follow the same terminology.
- Islamic finance should emphasize adequate teaching, training, and research in the desired specialization.
- Islamic banks can look into increasing their size by considering mergers and acquisition, or forming a strategic alliance with the conventional banks.

Islamic financial products are more complex than their conventional counterparts. The major banks should provide extensive front line training that covers not only the product features, but also how the transactions are processed. This will help the clients to have a better understanding and to ensure they are fully compliant with the Shariah law.

The future growth of Islamic finance largely depends on the nature of innovation introduced in the market and there should be Islamic financial instruments developed to enhance liquidity, and develop strong secondary and interbank markets.

In conclusion, there is definitely a potential for Islamic finance to grow and the financial industry is getting very competitive. The Islamic financial institutions have to overcome all these challenges and develop such a system which would allow clients to choose financial instruments that are compatible with their business needs, social values and the most important religious beliefs.



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