

Islamic Banking and Finance

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<p>The objective of this research is to introduce the basics principles and concepts of Islamic banking and financial system, also understanding its appearance in non-Muslim countries in order to see the perspectives of Islamic banking in the western market. The main reason of choosing this an interesting topic to explained by rapid growth of Islamic financial institutions in both Muslim and western countries.</p> <p>Islamic bonds “Sukuk” are considered the most important Islamic financial instruments when discussions come to Islamic finance in general. The main principle that differentiates the Islamic bonds from conventional bonds is that the Islamic bonds are mainly asset-based investment not just asset-backed investment.</p> <p>This research include introduction of the Islamic Banking and finance system, and main types of contracts of Sharia-based banking and finance. Also examing the risks could be face the Islamic financial institutions in western countries. At this research focused on Islamic bonds (sukuk) which is very important in Islamic finance, because is get bigger than the other Islamic banking products, with an intersting coparison between convetional and Islamic bonds.</p> <p>The results of this research show that, the Islamic financial institutions started to spread further in Europe and north America. With a big and an important transformation of financial institutions work compred last decade. It means financial authorities and conventional banks of western countries have to be prepared to imprtant innovation and be ready to face some obstacles. Although Islamic banks are more liquid and perform better in one efficiency ratio, conventional banks prevail with respect to profitability, solvency and credit risks.</p> <p>Academic articales, e-books, web sources and presentations were used as sources to writing this an important research. All the sources are carefully chosen cause of plenty of irrelevant informations about Islamic banking and finance system field</p>	
Keywords Islamic Banking, Conventional Banking, Sharia Compliance, Islamic bonds (sukuk).	

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1 Introduction

Islamic banking and finance system distinguish from the conventional financial system is based on a comprehensive system of ethics and moral values stemming from the Islamic religion. Unlike conventional finance, Islamic finance is founded on overarching principles that constitute the guidelines governing any Islamic economic or financial dealings.

(Omar.M 2013)

Islamic banking is a banking system that is consistent with the Sharia'a (Islamic law) and, as such, an important part of the system is the prohibition on collecting riba (interest or usury). The Sharia'a also prohibition trading in financial risk because this is seen as a form of gambling, something forbidden in Islam. Another prohibition under the Sharia'a is that Muslims cannot invest in businesses that are considered haram (forbidden or sinful) such as those that sell alcohol, pork, engage in gambling or produce un-Islamic media. (Altiby 2010).

As of 2014, sharia-compliant financial institutions represented approximately 1% of total world assets. By 2009 there were over 300 banks and 250 mutual funds around the world complying with Islamic principles and as of 2014 total assets of around 2\$ trillion were sharia-compliant. According to Ernst & Young, although Islamic banking still makes up only a fraction of the banking system of Muslims, it has been growing faster than banking assets as a whole, growing at an annual rate of 17,6% between 2009 and 2013, and is projected to grow by an average of 19,7% a year to 2018.

In recent years, there were many efforts exerted by Islamic financial regulatory bodies like the Islamic Financial Services Board (IFSB) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to develop regulatory framework for Islamic financial institutions, which include capital adequacy standards, risk management framework, and corporate governance standards. Another goal of organizations such as these was to harmonize Islamic financial practices like financial reporting, accounting treatments, and disclosure requirements with the internationally accepted standards and practices. Those efforts are aiming for enhancing and strengthening the regulatory framework in order to ensure a safe and sound Islamic financial system and to smoothly and effectively integrate and harmonize the Islamic financial system and practices with the international financial system and practices. (Altiby A, 2010).

Finally, corporate governance issue in Islamic banking is one of the serious issues that need to be carefully considered. The investment account holder's right and the nature of

their relationship with Islamic banking is one of the topics that is unique to Islamic banking. (Altiby A,2010).

1.1 Importance of Islamic banking and finance

There are three main reasons, why it is important the Islamic banking and finance, Islamic finance has a niche hold on the market, and it is growing at a tremendous rate.

Islamic finance has developed into a solid industry that complements conventional banking, only a fraction of the available liquidity is actually invested in the sector (2% of global banking assets) through it does offer great potential and further growth prospects (is growing more than 20% annually). represent the highest level of liquidity in today's global market, a market hungry for liquidity. The Islamic market demands a specific expertise that combines solid financial knowledge with that of Islamic finance market.

During the 90s, Islamic financial institutions became increasingly innovative and developed more complex instruments and structures to meet the demands of modern day business. In recent years, driven by the oil financial liquidity and an increase demand, the industry witnessed a large expansion, both in terms of its size, as well as in the financial innovation of the new developed products. Therefore, it is becoming a global industry that needs global expertise. A deeper understanding of Islamic finance it will help us the debate on the new financial order. Islamic finance can offer some food for thought in the financial crisis. For example, the industry was less effected by the crisis because its intrinsic features help the stabilization of credit growth, promote as asset-based investment, foster economic productive transactions and thus a reduction of systemic risk, and for the most part help to have a balanced leverage. In short, the market of Islamic finance has developed itself as a serious alternative for conventional banking and covers a wide products range. (Iraj T, Kabir M, 2011).

1.2 The goal of research

Global financial system runs into trouble in 2007-2008. Subprime mortgage crisis was one of the starting point, however the collapse of Lehman Brothers and Fannie Mae were the most shocking to the world financial system. While many western banks defaulted during that period, no major Islamic bank default was reported during the crisis. The main question of this research is indeed what methods used by the Islamic banks to avoid from the current crisis.

The purpose of this research is to explain the basic principles and ethics of the Islamic banking and finance system. In order to promote it as an alternative to conventional banking in a western market. And to look at these principles of operating in the market can be practical and furthermore, can it provide alternative methods of dealing with financial problems. The aim is to identify whether different financing modes have impact on bank's performance. Also the concept of free interest rate will be analysed and what methods an Islamic banks used instead of interest rate.

The current research's main and sub questions are as follows:

- How does work the Islamic bonds (sukuk), what the benefits of Islamic bonds to western countries?

1. investigating the historical and financial sustainability of Islamic banks?

2. what kind of risks in Islamic banking work?

3. case study of importance Islamic bonds(sukuk), what is Islamic bonds, how does it work (Sukuk).?

4. what issues and challenges of Islamic Banking?

1.3 Structure of the research

In the first chapter which is introductory chapter that gives us a brief preview of the entire thesis related with ever fast growing Islamic banking industry in the capital market of the world. It also tells us about the structure of the research and how the research methodology will be used to conduct the research.

In the second chapter is related with literature of Islamic banking and finance. This section of research will present the Islamic banking and finance principles and methods to fund the banks and finance institutions.

The third chapter is a description of risks of Islamic banking and finance. Also explaining types of risks and how can manage it.

The four chapter is the empirical part, we focused about Islamic bonds which is sukuk. Understanding it and how it works with sharia compliant. Exploring how the sukuk market size on? And we made a comparison between sukuk and conventional bonds.

In the chapter five we show the Islamic banking and finance has many challenges and obstacles, and how facing them through use it. We see also the AAOIFI (The Accounting and Auditing Organization for Islamic Financial Institutions) role, trying to promote it, and giving solutions, supervisory and other assistance issues.

2 History of Islamic banking and finance system

The chapter is related with literature of Islamic banking and finance system. This part of research will present the Islamic banking and finance principles and methods to fund the banks and finance institutions. As mentioned early, Islamic bank follows Sharia principle, which is based on profit and loss sharing principle.

Islamic Finance started in the 1970s in the Middle East and North Africa region to primarily provide banking services to the Muslim population.

In fact, the basic idea of Islamic banking can be stated simply. The operations of Islamic financial institutions primarily are based on a PLS principle. An Islamic bank does not charge interest but rather participates in the yield resulting from the use of funds. The depositors also share in the profits of the bank according to a predetermined ratio. There is thus a partnership between the Islamic bank and its depositors, on one side, and between the bank and its investment clients, on the other side, as a manager of depositors' resources in productive uses. (Kettell B.2011).

The mid-twentieth century writing on Islamic finance has given rise to practical discussions on the subject, which has in turn raised the issue of replacing conventional financial practices with alternatives that are in compliance with Islamic law. Sharia 'a denotes the Islamic law that governs all aspects of Muslims' lives. It is derived from the Quran and the Sunnah, which is the saying and examples set by the Prophet Mohammed. The development of modern Western banking goes back to the mid-seventeenth century, when development in mathematics and statistics provided powerful tools for financial mathematical science. These tools were developed over 300 years, and as a consequence, we have a robust interest-based financial system in place. At the same time, the legal and regulatory framework for the Western banking model has come a long way. (Altiby O. 2010)

2.1 Six key Islamic Banking principles

The principles of Islamic finance are established in the Quran, which Muslims believe are the exact. Words of God as revealed to the Prophet Mohammed. These are Islamic principles of finance can be narrowed down to six individual concepts.

- Predetermined loan repayments as interest (riba) is prohibited.
- Profit and loss sharing is at the heart of the Islamic system.
- Making money out of money is unacceptable, all financial transactions must be asset-backed.
- Speculative behaviour is prohibited.
- Only Sharia'a-approved contracts are acceptable.

- Contracts are sacred. (Kettell B, 33)

2.1.1 Predetermined Payments are Prohibited

Any predetermined payment over and above the actual amount of principal is prohibited. Islam allows only one kind of loan and that is qard al hassan (literally meaning good loan), where by the lender does not charge any interest or additional amount over the money lent. Traditional Muslim Jurists have construed this principle so strictly that, according to one Islamic scholar. The principle, derived from this quotation, emphasises that any associated or indirect benefits that could potentially accrue to the lender, from lending money, are also prohibited. (Kettell B, 2011)

2.1.2 Profit and Loss Sharing

The principle here is that the lender must share in the profits or losses arising out of the enterprise for which the money was lent. Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in a business instead of becoming creditors. Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, service companies or simple trade deals. This is unlike the interest-based commercial banking system, where all the pressure is on the borrower who must pay back the loan, with the agreed interest, regardless of the success or failure of his venture. The objective of all this is to encourage investments and thereby provide a stimulus to the economy and encourage entrepreneurs to maximise their efforts to make them succeed. (Kettell B, 2011).

2.1.3 Making money out of money is Not Acceptable

Making money from money is not Islamically acceptable. Money, in Islam, is only a medium of exchange, a way of defining the value of a thing. It has no value in itself, and therefore should not be allowed to generate more money, via fixed interest payments, simple by being deposited in a bank or lent to someone else. (Kettell B, 2011).

2.1.4 Uncertainty is Prohibited

Gharar (uncertainty, risk or speculation) is also prohibited, and so any transaction entered into should be free from these elements. Contracting parties should have perfect knowledge of the counter-values intended to be exchanged as a result of their transactions. In this context the term counter-values is used in the sense of something being deferred, either the price paid or the commodity delivered. Deferral of payment is an acceptable form of debt under Islam, in contrast to predetermined debt in conventional finance. (Kettell B, 2011).

2.1.5 Only Sharia 'a-Approved Contracts are Acceptable

Conventional banking is secular in its orientation. In contrast, in the Islamic system, all economic agents should work within the ethical system of Islam. Islamic banks are no exception. As such, they cannot finance any project that conflicts with the Islamic moral value system. For example, Islamic banks are not allowed to finance a wine factory, a casino, a night club or any other activity prohibited by Islam or known to be harmful to society. (Kettell B, 2011).

2.1.6 Sanctity of Contrast

Many verses in the Holy Qur'an encourage trade and commerce, and the attitude of Islam is that there should be no impediment to honest and legitimate trade and business. Just as Islam regulates and influences all other spheres of life, so it also governs the conduct of business and commerce. Muslims have a moral obligation to conduct their business activities in accordance with the requirements of their religion. They should be fair, honest and just towards others. A special obligation exists upon vendors because there is no doctrine of caveat emptor in Islam. (Brian Ketell, 2011).

2.2 Structure of Islamic Financial system

The Islamic financial system has evolved into a viable and vibrant component of the overall financial system, complementing the conventional financial system. The rapid progress of the Islamic banking system, accentuated by significant expansion and developments in Islamic banking and finance has become increasingly more important in meeting the changing requirements of the new economy. Four structures have been used to assist Muslims to acquire their homes in a manner consistent with the Sharia 'a: (Omar M, 2013).

- Murabaha
- Ijara wa Iqtina
- Diminishing Musharaka
- Istisna'a

2.2.1 Murabaha

Literally, Murabaha means a profitable sale and it is also sometimes called Bai'a Bi-thaman Ajil, meaning deferred payment sale. Murabaha, in this context, is essentially an instalment sales contract for property. Of all Islamic approaches to the question of leveraged home acquisition, this method is most consistent with the conventional house purchase processes. Murabaha is a form of asset finance that involves the lender purchasing the asset, back to back with a sale of the asset, to the borrower, at an increased price. This increased price reflects the interest otherwise payable. (Omar M, 2013).

2.2.2 Ijara wa Iqtina

In this transaction, the customer (lessee) selects a property and the investor buys it. The investor (lessor) then agrees an operating property lease with the customer/bank. The investor promises to sell and the customer promises to buy the property. The customer pays rent, as well as contributing to a savings fund, which is structured to accrete to a level allowing the customer to buy out the property from the investor. The savings fund may be initiated with a large initial payment similar to a conventional down-payment.

The lessor in the Ijara wa Iqtina contract is the financier/bank and the lessee is the customer. A common model for equipment, car and house financing in North America is based on leasing or lease-purchase. Under the Islamic equivalent, the Islamic financial institution buys the financed asset and retains the title through the life of the contract. The customer makes a series of lease payments over a specified period of time, and may

have the option at the end to buy the item from the lessor (and owner) at a pre-specified residual value. The period of the lease and lease and the rent payments may be made such that the final payments are only symbolic. The concept requires a sharia 'a modification to the conventional house purchase process to allow the investor or the bank to take the place of the consumer in the purchase contract. (Omar M, 2013).

2.2.3 Diminishing Musharaka

Diminishing Musharaka is a special form of Musharaka, which ultimately culminates in the ownership of the asset, or the project, by the client. The principles which would be applied for any project. It operates in the following manner. The Islamic bank participates as a financial partner, in full or in part, in a project with a given income forecast. An agreement is signed by the partner and the bank, which stipulates each party's share of the profits. However, the agreement also provides payment for a portion of the net income of the project as repayment of the principal financed by the bank. The partner is entitled to keep the rest. In this way, the bank's share of the equity is progressively reduced and the partner eventually becomes the full owner.

There are four steps in a Diminishing Musharaka as applied to home financing:

- The bank tenders part of the capital required for the house purchase in its capacity as a participant and agrees with the customer/partner on a specific method of gradually selling its share of the house back to the partner.
- The customer/partner tenders part of the capital required for the house and agrees to pay an agreed upon amount and rent in return for the ultimate full ownership of the property.
- The bank progressively sells its share of capital. The bank expresses its readiness, in accordance with the agreement, to sell a specific percentage of its share of capital with the rental element decreasing.
- The customer/partner pays the price of that percentage of capital to the bank and the ownership is transferred to the customer/partner. (Omar M, 2013).

2.2.4 Istisna'a Contract

Istisna'a is an Islamic term meaning "manufacturing" and is applied to construction finance. With an Istisna'a contract the consumer asks the bank to finance the construction of a house. The bank engages a builder or the consumer to build, with the bank's funds,

the desired structure or property that the bank has purchased. Upon completion of the development, there may be an outright cash sale, a Murabaha sale, an Ijara wa Iqtina or a Diminishing Musharaka partnership. (Omar M, 2013).

2.3 Islamic Modes of Financing

Islamic modes of financing are designed in such a way that they affect both the assets and liabilities of bank's balance sheet and are divided into two major categories. They are based on PLS (profit-and-loss sharing, which is a core mode) principle and NPLS (non-profit and loss sharing, which is a marginal mode). The following figure below provides a summary of the two modes of financing. These modes are central to formulating, designing and structuring all financial products and instruments of banking, insurance and capital markets within the Islamic financial industry. From the offset, one can observe that they are both performing tremendously different actions; this is because Islamic banking is based on Islamic law, and hence all transactions, product features, business approaches, investments aims, and responsibilities are based purely on sharia 'a principles, which are completely different from conventional banking. (Mondher B, 2013).

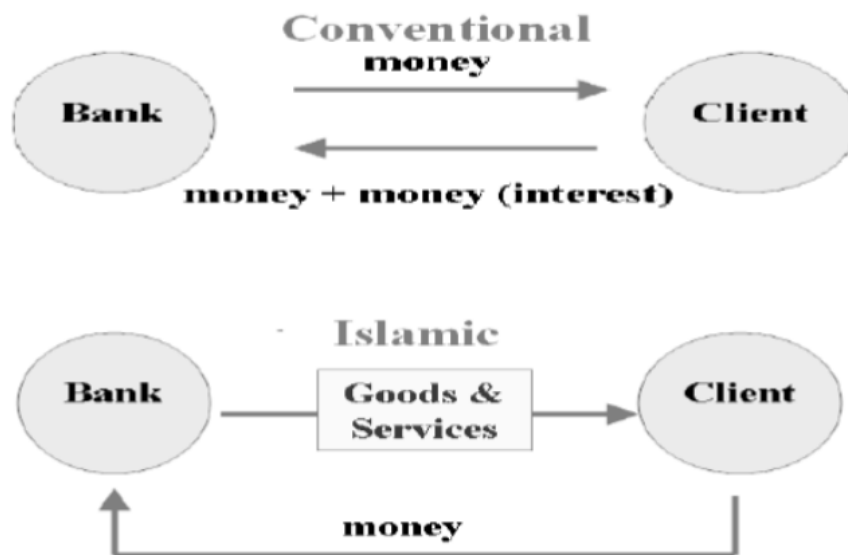


Figure 1. Mode of finance.
Source: Yaqubi (2006)

The resources made available to an Islamic bank belong mostly to depositors and the bank puts these resources into different contracts in its capacity as attorney and trustee of the people.

The prerequisite qualifications for those wishing to apply for finance from an Islamic bank are as follows: (Iraj T and M.Kabir, 2011).

2.3.1 Trust and Dependability

The Islamic bank must ensure that the applicant enjoys a good reputation for being a dependable partner and will look for such things as trustworthiness, social standing, order and discipline, conduct, extent of commitment to meeting responsibilities, character, social behaviour, faith, moral piety, educational background and spiritual devotion. (Iraj T and M.Kabir, 2011).

Technical Qualification and Suitability

In reality technical ability, managerial calibre and professional background should speak for themselves. The injection of money in the form of capital will be fruitless if management techniques, technical administrative and financial systems and internal controls are lacking. From the outset, the bank has to act as a friend and adviser to applicants also should refrain from giving them a financial burden beyond their capacity to deal with. (Iraj T and M.Kabir, 2011).

2.3.2 Intellectual and Financial Capability

It is vital, then, that the character and reasons for the requested finance be thoroughly investigated along with the position and financial standing of the applicant so that the finance may be made available on the basis of the firm's real needs and in proportion to its financial and technical capacities to ensure that the bank's share of profit does not suffer. The possibility of abnormal economic conditions or unforeseen external problems arising for the applicant should not be overlooked either.

The fact that the Islamic bank has wide-ranging responsibilities places it at the opposite end of the spectrum to the conventional bank, which feels no sense of responsibility toward a firm facing external problems. In such circumstances, the conventional bank acts as parasite and the only way it can help firms experiencing severe difficulties is to lend

them even more, at even higher rates of interest, which in turn simply complicates the situation even more.

Generally, Islamic banks need to know the share of the capital the applicant is prepared to invest in the specific project. In normal circumstances, the greater the applicant's stake, the more motivated he will be to ensure the project's success. This also leaves more of the bank's funds available to other potential applicants. (Iraj T and M.Kabir, 2011).

2.3.3 Collateral

In the conventional banking system, "collateral" is usually taken to mean the pledge of an acceptable (generally solid and redeemable) asset as security for a loan or credit. But in the different philosophical setting of Islam, where people matter, and man plays the central role, a different value system is practiced. Here "collateral" is understood to stand for attainment of certainty and security based on the solid foundation of the transaction and good performance of the undertakings to minimize the risk to return on the capital. In this context, the word "collateral" is generally replaced by the phrase "sufficient security". The security needed here has much to do with proper utilization of the code of ethics combined with the intellectual property of the applicant, which has rarely, been used before.

In brief, any action taken by an Islamic bank is taken because it is considered to be the trustee agent or advocate for its depositors. (Iraj T and M.Kabir, 2011).

2.4 Sources of Funds for Islamic Banks

The Islamic banks also need funds to operate its banking activities. The original source of Islamic funds has to be ascertained to ensure it come from "halal" sources. Under a dual window banking operation, the initial paid-up capital is normally given on al-Qard basis (benevolent loan which is free of interest) from conventional counterpart thus there should not be any issue in regard to the source of the funds.

In general, Islamic banks rely on the following sources of funds:

2.4.1 Current Accounts

All Islamic banks operate current accounts on behalf of their clients, both individuals and businesses. Current accounts are sometimes classified as "other accounts" in the financial statements. These accounts are operated for the safe custody of deposits and for the convenience of customers. The main characteristics of these accounts are listed:

- Current accounts govern what is commonly known as demand deposits. These accounts can be opened by individuals or companies, in domestic or foreign currency.
- The bank guarantees the full return of these deposits on demand and the depositor is not paid any share of the bank's profits, interest or return in any other form.
- Depositors authorise the bank to use funds at the bank's own risk. Hence, if there is any profit resulting from the employment of these funds, it accrues to the bank, and if there is any loss, it is also borne by the bank.
- There are no conditions with regard to deposits and withdrawals.
- Usually account holders have a right to draw cheque on their accounts.

There are two dominant views with the Islamic banking community about current accounts. One is to treat demand deposits as Amanah (trust) accounts. This view is adopted by the Jordan Islamic Bank, which operates a "trust account" instead of a current account. The Jordan Islamic Bank defines a trust account as "cash deposits received by the bank where the bank is authorised to use the deposits, at its own risk and responsibility with respect to profit or loss, and which are not subject to any conditions for withdrawals or deposits". These deposits are handed over to the bank by depositors, as a trust, and the bank does not have the authority to use them without first obtaining the specific permission of the owner of the funds.

The other view is to treat demand deposits as Qard Hasan (interest-free loans). This view has been adopted by Iranian Islamic banks, which refer to current accounts as "Qard Hasan current accounts". According to this view, money deposited in these accounts is a benevolent (or interest-free) loan from the depositor to the bank. The bank is free to use these funds at its own risk without any return to the depositor and without needing and authorisation. (Omar M, 2013).

2.4.2 Saving Deposits

Although all Islamic banks operates saving accounts, there are some differences in the operation of these accounts. A typical example is that of Malaysian Islamic bank, which defines savings deposits; The bank accepts deposits from its customers looking for safe custody of their funds and a degree of convenience in their use together with the possibility of some profits on the principle of Al-Wadia. The bank requests permission to use these funds so long as these funds remain with the bank. The depositors can withdraw the

balance at any time they so desire and the bank guarantee the refund of all such balances. All the profits generated by the bank from the use of such funds belong to the bank. However, in contrast to current accounts, the bank may, at its absolute discretion, reward the customers by returning a portion of the profits generated from the use of their funds from time to time.

Another similar example about saving accounts, at Dubai Islamic Bank operate as follows:

- Saving accounts are opened with the condition that depositors provide the bank with an authorisation to invest.
- Depositors have the right to deposit and withdraw funds.
- The profits in savings accounts are calculated on the minimum balance maintained during the month. Depositors participate in the profits of savings accounts with effect from the beginning of the month following the month in which the deposits are made.
- A minimum balance has to be maintained in order to qualify for a share in profits. (Omar M, 2013).

2.4.3 Investment Deposits

Investment deposits are based on the application of the Mudaraba contract. Investment deposits are Islamic bank's counterparts to term deposits or time deposits in the conventional system. They are also called profit and loss sharing (PLS) accounts, investment accounts or sometimes participatory accounts.

The following characteristics of Mudaraba are of significance for the sources of bank funds:

- The division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump sum or a guaranteed return.
- The investor is not liable for losses beyond the capital has contributed.
- The Mudarib does not share in the losses expect for the loss of his own time and effort.
- The Mudaraba can be general purpose or for a specific purpose.

(BKettel, 2011)

3 Risks of Islamic banking and finance

This chapter of research tries to investigate risks of Islamic banking and finance system. This part explaining types of risks and how can manage it and what methods used to avoid from crisis could happened it.

Islamic banks are less risky and more resilient than their counter parts in terms of banks capital requirement and mobilization of deposits. Somewhat perversely, the global financial crisis presented a big opportunity to the Islamic banking and finance industry. In 2008-2009, the Islamic banking industry was estimated to have experienced asset growth of 31,8% compared to 12,6% in the conventional banking. The Islamic bank total assets range between \$1,88 trillion to \$2,1 trillion in 2016 and are expected to reach \$ 3,4 trillion by 2018 globally. It provides an alternative financial services option to all consumers and investors.

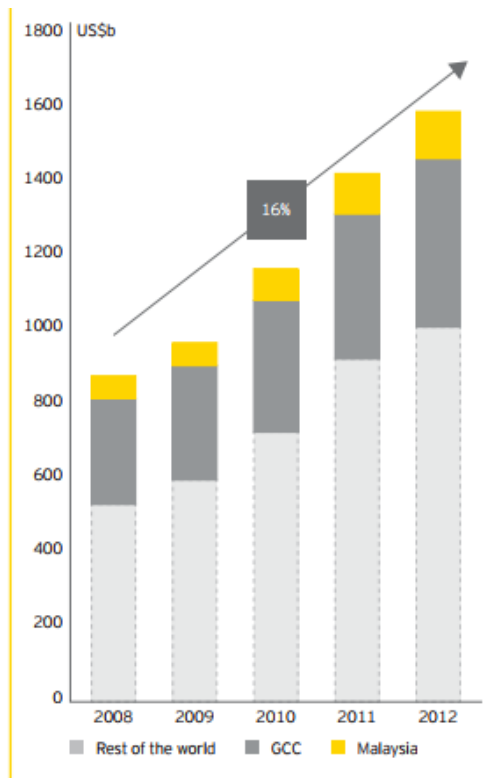


Table 1. Global Islamic banking assets

Sources (Central Banks, BMI, EY analysis).

In general, Banking risk falls into four categories: financial, operational, business and event risk. Islamic financial institutions face a unique mix of risks and risk-sharing arrangements resulting from the contractual design of instruments based

on the principles of Sharia'a liquidity infrastructure, and the overall legal governance. Institutions Offering Islamic Financial Services (IIFS) are set on different foundations from conventional financial institutions. The generating of profit in IIFS takes second place to adherence to Sharia'a. (Altiby Ahmed 2010, 54 – 55).

Financial Risks	Operational Risks	Business Risks	Event Risks
Credit risk	Legal risk	Country risk	Banking crisis
Equity investment risk	Failure risk	Withdrawal risk	Exogenous
Market risk	Fiduciary risk	Settlement and prepayment risk	
Liquidity risk	Shari'ah-compliance risk	Volatility risk	
Rate of return risk		Reputation risk	
		Equity	

Table 2. Islamic Banking risks.
Source: Islamic financial services Board (2005b).

3.1 Financial Risk in Islamic banking

The sub categories of financial risk are credit risk, equity investment risk, market risk, liquidity risk, and rate of return risk (displaced commercial risk).

3.2 Credit Risk in Islamic Banking and finance

Credit risk is the most common source of risk in Islamic and conventional banks and the major reason for bank failure. Therefore, one of the primary concerns of a supervisor is to ensure that banks have a well-articulated and implemented credit policy in place.

In Islamic finance, credit risk exposure arises in connection with:

- The accounts receivable in murabahah contracts, where the bank delivers the assets but does not receive the payments. And in non-binding murabahah, if the customer does not accept the assets that have already been purchased by the bank.
- Counterparty risk in salam contracts, the accounts receivable, and counterparty in contracts if the bank fails fully or partially to deliver the assets.
- Lease payments receivable in ijarah contract, and sukuk held to maturity in the banking book.
- When the bank acts as rab el mal in mudarabah investment, and has no control over the transaction, assessing credit becomes difficult.

Credit risk management in Islamic banks is more complicated than conventional banks due to many reasons, such as the case of default by the counterparty and the fact that Islamic banks are prohibited from charging any accrued interest or imposing any penalty, except in the case of deliberate delay. During this delay, the bank's capital is stuck in non-productive activity, and the bank's investors/depositors do not earn any income.

Also, in the case of negligence or misconduct of the Mudarib or Musharakah partner, the bank has to go into a more complicated recovery process than what would be applied in conventional banks. In Islamic banking, it became common practice to request additional collateral from the customers for risk mitigation purposes, which in turn has its own difficulty, particularly in the case of liquidating or trying to sell. (Altiby A, 2010).

3.3 Equity Investment Risk

One of the unique risks associated with the Islamic banks is the equity investment risk, as conventional banks do not enter into such transactions, which involve investing in equity-based assets. Islamic banks are exposed to two different types of risk while holding the equity instruments, depending on the purpose of the instruments:

- The first type of risk, which is our concern in this part, arises as a result of the holding of equity for the purpose of investment. In this case, the instruments are mainly based on mudarabah and musharakah contracts.
- The second type of risk arises as a result of the holding of equity for trading or liquidity purposes, which are dealt with under market risk.

Islamic banks, while investing in mudarabah and musharakah instruments, are not only exposed to high market, liquidity, and credit risk, but they also are exposed to high volatility in gains as well as to loss of capital. Through such instruments, the investments, however contribute significantly to the bank's earnings.

The involvement in the management of investment during the life span of the contract represents the major difference between mudarabah and musharakah. In mudarabah, the bank as the capital provider (rab el mal) is considered to be a silent partner with no control power over the management, whereas the other partner as mudarib has the full power to manage the investment. In case of failure, the

bank will bear the losses while having no power to influence the other party to take the necessary remedial measurements when needed. In addition, this gives rise to moral hazard problems, because the other may have a high-risk appetite and take excessive risk, while the bank may not have the same risk appetite.

In musharakah, however both the bank and the other party are partners investing their funds together, therefore, the capital of the other party is also at risk, which will result in reduction of the moral hazard problem. The bank in this type of contract, has the option to be a silent or an active partner. Due to the unique features of the equity investments contracts and the high risk associated with them, banks are required to take the necessary measurements prior to and during the life span of the contract.

There are three risk management principles with regard to this type of risk, IFSB principles (Altiby Ahmed, 2010).

for equity investment risk:

- IIFS shall have in place appropriate risk management and reporting processes in respect of the risk characteristics of equity investments, including mudarabah and musharakah investments.
- IIFS shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IIFS and the mudarib and/or musharakah partner.
- IIFS shall define and establish the exit strategies in respect of their equity investment activities, including extensions and redemption conditions for mudarabah and musharakah investments, subject to the approval the institution's sharia'a board.

3.4 Market Risk

Market risk is defined as the risk of losses in on-and-off balance sheet positions arising from unfavourable movements in market price (IFSB 2005b). IIFS are exposed to a higher market risk than conventional banks due to the asset-backed nature of their finance instruments.

Market risk rises in many of the Islamic finance contracts, some examples are:

- Ijarah: in case the lessee default, then the IIFS have to either re-rent or dispose of the asset at the market price, which may be lower than the agreed upon price or rent.
- Ijarah Montahiya Beltamaluk (IMB): if the lessee defaults, there is a risk on the carrying value of the leased asset, which is taken as collateral if the market price is lower than the book value.
- Salam: commodity price fluctuations on the long position exists until the final disposal.
- Parallel Salam: if the bank fails to deliver the items and needs to buy the same, at a higher price, from the market to meet its obligations.
- Foreign exchange: fluctuations arising from foreign exchange spot rate changes in cross-border transactions and the foreign currency receivables and payables.

IIFS according to sharia'ah principles, are not allowed to earn returns from speculative transactions or transactions connected to future events, such as hedging against risk or other derivatives. Trading books in Islamic banks are limited to traded equities, commodities, foreign exchange positions, and various forms of Sukuk. IIFS carry out many asset-based transactions in which they take ownership of physical assets as co-investors.

Market risk can be measured by the traditional exposure indicators, such as

- Net open position in foreign exchange.
- Net position in traded equity.
- Net position in commodities
- Rate-of-return gap measured by currency of denomination.
- Various duration measures of assets and liabilities in the trading books.

4 Islamic (sharia-compliant) Bonds sukuk

At this empirical part of thesis, I focused about Islamic bonds which is (sukuk). Understanding what is mean, and how is working with sharia based compliant. Exploring how the sukuk market size on? And how I did an important comparison between sukuk and conventional bonds.

I did an interview with Aho Petri. He is working in Nordea as Head of Institutional Sales Finland. During the interview I have got a useful information's and instructions, which were very exact and important to write this part of my research.

Bonds are tradable financial instruments issued by a company, or government, are typically long-term and allow the holder to receive interest before the distribution of profits to the shareholders. Bonds have been around for several centuries and were popular with kings who needed to borrow heavily to finance their war efforts.

Sukuk (plural of sakk, which is the Arabic word for certificate) is defined as certificates representing a proportional and undivided ownership right in tangible asset, a pool of predominantly tangible assets, or a business venture. These assets must be in a specific project or in investment activities that comply with shariah rules and principles. Sukuk is the Islamic equivalent of securities or bonds in the conventional system.

Sukuk currently issued have a shorter term than conventional bonds, typically 3-5 years. Sukuk holder owns a proportional share of the underlying asset, and has a financial right to the revenues generated by the asset. Sukuk are not a separate instrument, but are more like structures facilitating the funding of large projects, which would be beyond the capability of either an individual or a small group of investors. Sukuk can be listed on recognized exchanges and, with exception of the sukuk al salam, are tradable. Like conventional bond market, sukuk can be bought from the issuer or in the secondary market.

4.1 Religious basis for sukuk

Al-Riba the literal meaning of interest or riba, as it is used in Arabic, means an excess or increase. In the Islamic terminology interest means effortless profit. Riba has been described as a loan with condition that the borrower will return to the lender more than the amount borrowed. Although a small minority of philosophers argue in favour of interest, the general opinion is that the Quranic ban on riba is absolute and without rationalisation.

Islam as revealed in the Qur'an, the teachings of Muhammad(pp) as well as its links to the revelations to the teachings of Moses(pp) and Jesus(pp). charging interest (called riba in Qur'an and ribit in the Torah) is divinely prohibited in Judaism and Christianity as it is also clearly and strictly prohibited in Islam. That is why it is believed that this can present the followers of the Abrahamic faiths (Judaism, Christianity and Islam) with wonderful window of historic proportions to cooperate together to bring to market a creditable, efficient, fair and equitable financing and banking system.

The main reason for the prohibition of riba, that is renting money to those who need it, is to prevent those who have money from taking advantage of and abusing the freedom of the poor and the needy. (Natalie Schoon, 2016).

Riba comes in various guises, but two main forms are distinguished:

- (Riba al naseeyah) this form of riba is the most basic form of interest and is the monetary compensation for an amount provided to a borrower.
- (Riba al fadl) this form of riba occurs when the price in a sale transaction is in excess of a fair market price or, put differently, when there is inequality of the exchanged counter values.

Textual Evidence for the Ban in Riba (interest), it comes from both of the primary sources of Sharia'ah law: the Qur'an and the Hadith. The following is taken from the Qur'an- Al-Imran S3:130 (O you who believe! Eat not riba doubled and multiplied, but fear Allah that you may be successful).

The following quote is from the Hadith: He speaks of in a dream related to the Prophet that there is a river of blood and a man was in it, and another man was standing at its bank with stones in front of him, facing the man standing in the river. Whenever the man in the river wanted to come out, the other one threw a stone in his mouth and caused him

to retreat back into his original position. The Prophet was told that these people, in this river of blood, were people who dealt in riba. (Hadith- Sahih Bukhari, 2.468, Narrated Samura bin Junadab, r.a).

Islamic scholars have put forward five reasons for the prohibition of riba:

- It is unjust
- It corrupts society
- It implies improper appropriation of other people's property
- It results in negative economic growth
- It demeans and diminishes human personality.

4.2 Concept of Sukuk

What are the reasons behind the recent growth in Islamic finance? One is the strong demand from a large number of immigrant and non-immigrant Muslims for Shria-compliant financial services and transactions. A second is growing oil wealth, with demand for suitable investments soaring in the GCC region. A third is the competitiveness of many of the products, attracting Muslim and non-Muslim investors.

At the heart of the sukuk structure lies a special purpose vehicle (SPV) that purchases the asset from the original owner on behalf of the sukuk holders. The SPV is often set up as part of the group of companies selling the asset and hence raising the funds. In the interest of the sukuk holders, the SPV needs to be bankruptcy remote, which means that any insolvency of original seller of the asset does not affect the SPV. In addition, the SPV should not attract any negative tax implications and will need to be established in a tax-friendly jurisdiction.

With the exception of murbaha, any of the earlier mentioned partnership and predictable return structures, as well as wakala, can be the underlying structure for a sukuk. Murabaha is not applicable for securitisation since the asset has already been delivered but payments are deferred; securitising these transactions would therefore amount to debt trading. The exception to this is in Malaysia where, following the Shafi'i school of thought, regulators and market players have permitted this type of securitisation. (Natalie Schoon, 2016).

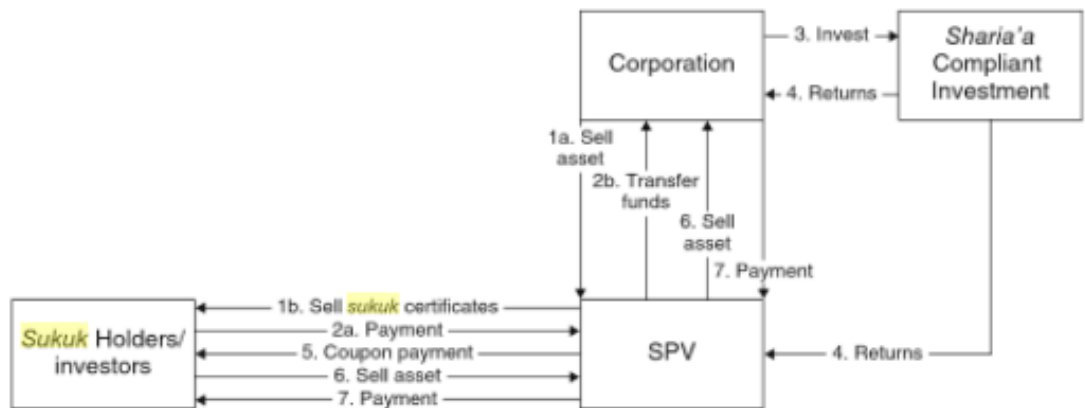


Figure 2. Generic Sukuk structure.
Source: Natalie Schoon 2016.

Although the steps differ for the different structures, the underlying principles remain the same and involve the following steps once the SPV is in place: (Natalie Schoon, 2016).

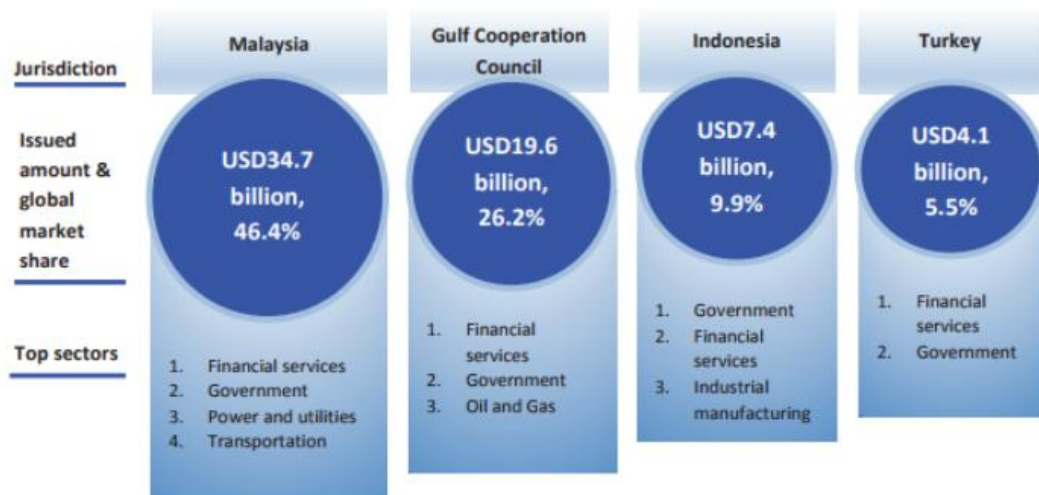
- The corporation sells an asset to the SPV, which the SPV divides up in equal units of usually \$ 1,000 or £ 1,000 and transfers on to the sukuk holders. In the event that the underlying transaction is a musharaka or mudaraba the underlying asset can be represented by a share in the corporation or partnership.
- The sukuk holders transfer the funds representing the number of certificates they bought to the SPV. Which transfers the total proceeds minus any costs to the corporation.
- The corporation invests the funds in the Sharia'a-compliant investment stipulated in the contract.
- The Sharia'a-compliant investment either generates profits or losses (for partnership type contracts) or pays a return (for predictable return type instruments).
- The SPV collects profits and losses or returns and pays (typically quarterly) coupons to the sukuk holder.
- At maturity, the sukuk holder sells the asset to the SPV, which in turn sells it back to the corporation.
- Money flows from the corporation to the sukuk holders through the SPV.

4.3 Sukuk market

In 2016, global sukuk market witnessed a rebound after three consecutive years of decline following its peak in 2012. Global sukuk issuance posted a solid growth of 13,2%

from previous year to reach 74,8\$ billion. Overall, sukuk issuer profile remained broadly like historical trends, with Malaysia continued to be the main driver for sukuk issuance for the year, commanding a market share of 46,4% of total issuances, followed by Indonesia and the United Arab Emirates (UAE), accounting for 9,9% and 9,0% share, respectively. Total issuances of GCC countries stood at 19,6\$ billion, compared to 18\$ billion in the previous year, driven by higher issuances from sovereigns. Higher issuances from this region suggested sukuk remain an important source of funding in financing their budget deficits amidst low oil prices and export earnings. Elsewhere, Turkey recorded a notable rise in sukuk issuance at 4,1\$ billion for the year, supported by some number sovereign issuances with maturity ranging from one to five years.

Table 3. Top Sukuk Markets in 2018.
Source: Thomson Reuters, MIFC estimates



Britain is set to become the first non-Muslim country to sell a bond that can be bought by Islamic investors in a bid to encourage massive new investment into the City. Mr. David Cameron said in a speech on Tuesday at the World Islamic Economic Forum in London that the Treasury is drawing up plans to issue a 200£ million of sukuk, a form of debt that complies with Islamic financial law. The prime minister said it would be a “mistake” to miss the opportunity to encourage more Islamic investment in the UK and that the City of London should rival Dubai as a centre for sharia-compliant finance.

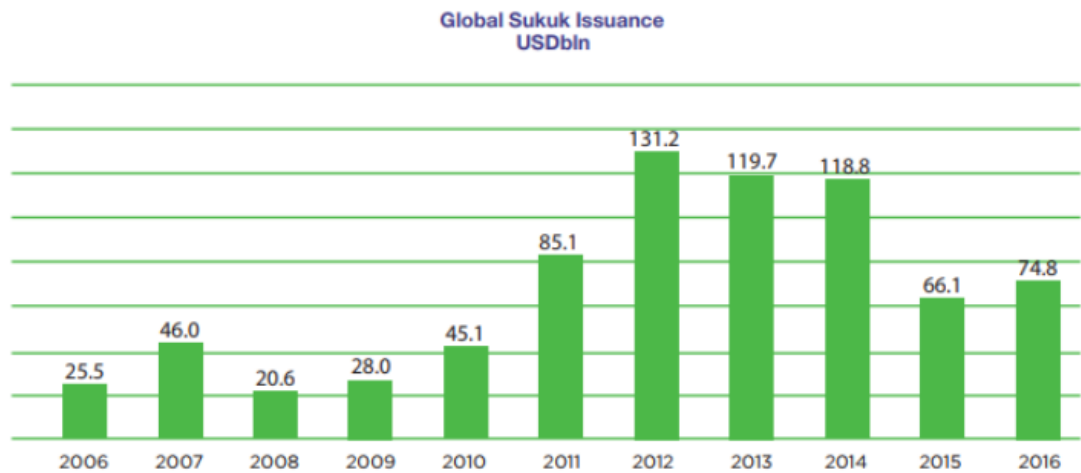


Table 4. Global Sukuk Issuance USAbn.
Source: Thomson Reuters, MIFC estimates.

The concept of sukuk market has widened from Muslim world to non-Muslim words because that consider the sharia-compliant products are ethical and tend to be more competitive than the conventional financial products. The United Kingdom became the first non-Muslim country to issue a sovereign sukuk in 2014.

Sukuk provide an ideal way of financing large projects for the public good that would otherwise not be possible. There are many economic activities or projects that are out of reach of individuals, companies or in the case of various developing Islamic economies, governments. In these cases, sukuk are perfect for financing these projects without falling into interest-based debt. This makes sukuk an important avenue for redistribution of wealth and achievement of social justice. The use of sukuk to fund large projects means that investors in sukuk are incentivized to help economies develop by creating and producing rather than by consuming or manipulating others. Islamic finance is based on principles of fairness and justice which are achieved by avoiding Riba.

Investors on the secondary market that are looking for investments that can be liquidated easily will find that sukuk are ideal. Investors can sell their securities and obtain the cost of their certificates. If the projects that back their sukuk certificates have generated profits, this result in a quick return in investment. This means that Islamic financial instruments are well suited for fund management. Banks or institutes can use part of their funds to purchase Islamic securities and then sell them on the secondary market when liquid assets are needed.

Global sukuk outstanding increased to a record of 349,1\$ billion as of December 2016, an 8,7% increase from 321,2\$ billion as at end-2015. By domicile, Malaysia secondary sukuk

market stood at 183,8\$ billion which representing a share of 52.6% of total sukuk outstanding. This was followed by Saudi Arabia and the UAE with market share of 16,3% and 8,9%, respectively.

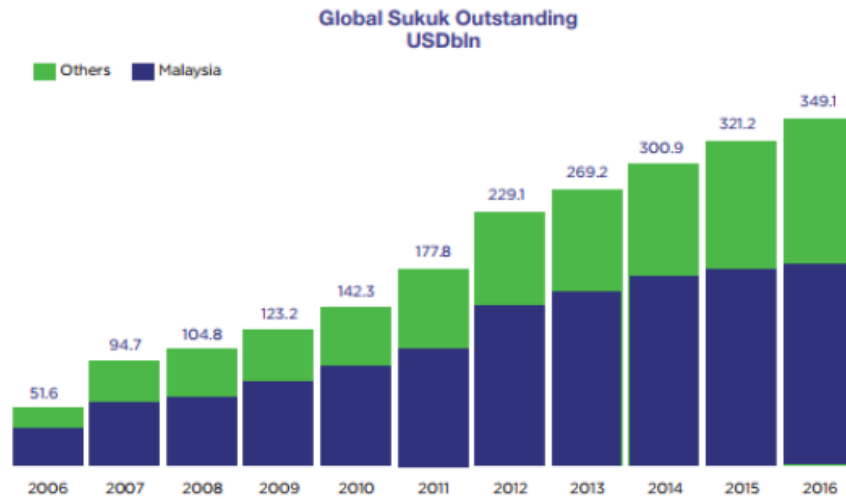


Table 5. Global Sukuk Outstanding USDbln.
Source: Thomson Reuters, MIFC estimates.

4.4 Comparison between Islamic bonds(sukuk) and traditional bonds

At this an important part we keep focus on differences between Islamic bonds (sukuk) and traditional bonds. According to the Auditing and Accounting Organization of Islamic Financial Institutions (AAOIFI), sukuk were officially defined in May 2003 as “certifications of equal value representing undivided shares in ownership of tangible assets, usufruct, and services in or ownership of the asset of a particular project or special investment activity.” Although the sukuk market is the fastest growing area of Islamic finance.

A major difference between the two kinds of bond is that conventional bond issuers pay interest to investors at regular intervals, whereas sukuk issuers share profits and losses with the parties to the business transaction. A second difference from conventional bonds is that, when there is a delay or default resulting from some unforeseen circumstances, the most amount due is not added to the principal to compute compound interest. A third major difference is asset ownership, sukuk are asset based rather than asset backed, and the asset must be Sharia compliant in both nature and use.

The Islamic bonds sukuk are priced according to the value of the assets backing them, but the conventional bonds pricing is based on credit rating. Sukuk can increase in value when the assets increase in value, while profits from conventional bonds correspond to fixed interest, making them Riba.

Sukuk holders are affected by costs related to the underlying asset, Higher costs translate to lower investor profits and vice versa. But the conventional bond holders generally aren't affected by costs related to the asset, project, business or joint venture they support. The performance of the underlying asset doesn't affect investor rewards.

The major differences between the two can be summarized as follows:

- Bonds are certificates of debt owed by the issuer, whereas sukuk are instruments that represent a proportionate and undivided ownership right over the asset in which the funds are being invested.
- Sukuk can only be issued for specific shariah-compliant purposes and shariah-compliant assets, whereas bonds can be issued for general unspecified purposes.
- Sukuk are based on the real underlying asset; therefore, the income must be related to the purpose for which the funding is used.
- In the case of sukuk, investors have ownership claims on the specific assets or the underlying business venture, whereas in bonds they have general creditors' claims on the issuer.
- The fact that shariah requires all finance to be routed to productive purposes rather than speculative activities ensure that it has real economic values to reduce the risk of uncertainty.
- Sukuk cannot be traded in the secondary market unless the underlying assets represented by the certificate comprise the majority of real assets and financial rights.

5 Issues and Challenges of Islamic Banking

At this part of research, I showed the Islamic banking and finance has many challenges and obstacles, and how facing them through using it. I saw also the AAOIFI (the Accounting and Auditing Organization for Islamic financial Institutions) role, trying always to promote it, and giving more solutions, suggestions, and supervisory and other assistance issues.

It is easy for the uninitiated to underestimate the difficulty of applying classical Islamic law to modern commercial transactions. Some believe that the law's dictates can be summed up in a set of vague and general ethical and moral precepts, which do not entail any precise system of legal procedures. In contrast, others assume that the legal restrictions are relatively few in number, concrete in nature, specific in application, and readily dealt with, leaving the rest of the field free for innovation and development.

5.1 Obstacles to the application of Islamic Law to Present Day Banking

The rationalising of those areas of Islamic law which relate to commerce and other financial activities, in order to create a legal framework for Islamic banking is not, according to Vogel's studies, all that simple then. First there is the nominalisation or provisional nature of much of Islamic jurisprudence (fiqh), which relies as much on the interpretive skills of individual Islamic scholars, extrapolating from both primary and secondary sources, as it does on the principal tenets enshrined in Sharia'a law. Divergences of opinion between the different schools of law complicate the picture further, as do the different methodologies that may be called upon when elaborating on the law. Then there is the particular issue of the pluralism of the fatwah, which again has its origins in the subjective and non-binding nature of many fiqh rulings.

5.2 Accounting and Corporate Regulatory Practices

A major problem that challenged the growth of Islamic banking was the absence of recognised guidelines on prudential, supervisory, accounting, auditing and other corporate regulatory practices. This resulted in ineffective accounting standards and created considerable difficulties when it came to be comparing financial statements issued by Islamic financial institutions and those of conventional financial institutions.

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is one of the key organisations involved in addressing these issues, with the aim of harmonising corporate governance with the ethical requirements of Sharia'a law. AAOIFI is an autonomous, international, non-profit-making corporate body which draws up Sharia'a-compliant accounting procedures, auditing methods, corporate governance frameworks and business ethics for Islamic financial institutions.

The objectives of AAOIFI are to develop accounting and auditing thoughts and standards relevant to Islamic financial institutions, to disseminate them to Islamic financial institutions, and apply this knowledge through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means.

5.3 Pluralism of Fatwabs

The pluralism of fatwabs relates to differences and disagreements between different applications of law (*furū'*) as distinct from the actual principles of law (*usul*). For example, the prohibition of *riba* (interest) vis-à-vis the prohibition of *'inah* sales (double sale by which the borrower and the lender sell and then resell an object between them, once for cash and once for a higher price on credit, the net result being a loan with interest). Whilst pluralism is not accepted in matters of principles of law, which are divine in character, Islam must nevertheless confront the problem of legal pluralism in other areas if it seeks to ensure that the rule of law be maintained.

5.4 The Problem of Applying Islamic Law in a Western Legal Environment

Again, according to Vogel's studies, although parties may agree by contract to abide by Islamic precepts, they cannot alter the surrounding legal system which in the end enforces their agreements. In nearly all Muslim countries today, civil and commercial codes have been greatly influenced by European legal civil systems, most commonly French, followed by English common law.

In areas of the law explicitly involving commercial matters, such as company law, banking and commercial paper laws, the laws applied strongly resemble French and Egyptian laws. Bearing in mind that Islamic banking began with the purpose of benefiting all society, situations such as bankruptcy merely offers delay and immunity from collections, not release, and the creditor's grant of delay is not compensated. European legal systems do not give that much leeway to the debtor as they do not take into account the Quran nor

accommodate the Sharia'a. Thus, we see the historical reasons for the challenges of integrating Islamic law into these various European legal systems. (Islamic Banking in south-east asia: its development and future, Angelo M.Vendaros, 73, 72,71,70,69,68,67).

6 Discussion

This part examines and overlooks the entire of thesis and summaries the research. This part also concludes the research conclusions and recommendations, will suggest for further research.

6.1 Conclusions

In recent years, Islamic finance has grown rapidly across the world at an estimated growth rate of 15-20% per annum. It offers bright prospects for those involved and thus, rapid growth outside its historical boundaries is expected to continue over time. The ethical principles of Islamic finance make them attractive to a wide spectrum of ethically-conscious clients who desire a socially just financial system. More Muslim-clients are choosing to invest in Islamic financial instruments and solutions available through long-established Islamic banks from Muslim countries. Muslims, as well as non-Muslims, banking customers in the West are also increasingly attracted by the ethical Islamic model. Recognizing the importance of Islamic finance, many financial players have decided to respond to the market demands. This was particularly through establishing new banks, switching from conventional to Islamic methods of banking operations, the establishment of Islamic windows, moving from Islamic windows to separate subsidiaries, and shifting from being a bank-like finance company to become a full-fledged bank. At the countries level, European governments are trying to out-compete each other in setting a viable framework for establishing Islamic finance.

This research would allow practitioners, through the evaluation of the performance of the Islamic banking sector to undertake the necessary corrective action in the event of under-performance and contribute to a better allocation of financial resources, and the results that are derived could thus constitute a tool to help the decision making for the monetary authorities having recently introduced products and Islamic banking system.

Making a bachelor's thesis is a learning process and I learned that I still have to learn more. Especially with improving my time usage and scheduling my work and results would be better. The sources of my theory-based work have been used in literature, articles and various websites. One remark, however, was Aho Petri appeared in many sources, both as factor and as an interviewee. Otherwise the sources are up to date, and sources of more than 10 years old have not been used at work. This strengthens the timeliness of the work. The research describes the concepts and backgrounds of the subject.

6.2 Recommendations

This part we take a look about what benefits can Westerns countries from sharia-compliant bonds. Sharia-compliant bonds were once seen as a pricy source of financing for governments and companies. But a growing pool of captive capital means the bonds are now less expensive than their conventional equivalents. Sharia-compliant bonds do not pay interest but instead entitle investors to a share in the returns generated by an underlying asset, such as property, making them Islamic-compliant. These bonds will support the expansion of Islamic banking in the western countries- providing economic benefits to non-Muslims and Muslims alike.

According to S&P's director Mr. Mohamed Damak of Islamic finance forecast greater standardization would be reached within the next three-to-five years, with multilateral organizations like Islamic development bank at work to establish a template for issuance and recent sukuk deals appearing more analogous across western countries.

The Sharia bonds theory is that the generally more prudent approach to debt and financing implicit within sharia principles, combined with the need to identify a specific asset, suggests a more cautious, or prudential approach to financing. This serves to align the Islamic banking industry with real world activity as opposed to financial engineering for the sake of creating products that only operate within the financial world.

It is also worth mentioning that the Islamic debt capital markets space is continually evolving, which means that new methods are being developed to overcome perceived constraints. As the whole industry grows, it can be expected that this process of improvement will continue.

When looking the future of Islamic banks and how may expand, it is may important to look three important aspects. From the perspective of the bank managers, acceptances they have already received and how they are spreading to the global market. The last five years, Islamic financial Institutions were taking root in many part of the world. Conventional banks also on the move to penetrate the Islamic markets and traditional Islamic banks that were operating in dominant Islamic countries banks were also investing to non-Islamic countries.

One manager explains future of the interest-free products:

“That assumption is not far-fetched considering that even the Vatican admitted, interest-free banking (Islamic bank) is the solution for these perennial booms and deposit economies” (Communication & Corporate affairs, Islamic bank).

Thus, the future of this research needs to elevate Islamic finance industry to the next level, the formulation of game-changing strategies must bring in elements that leverage on technology, accelerate innovation and develop well-rounded talent to meet future needs of Islamic finance institutions. These strategies offer an important opportunity to reinforce the foundations of a strong and resilient Islamic financial system, and advance its developments and contribute towards a more inclusive and stable global financial system.

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