Islamic Finance news

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MALAYSIA

Central Bank issues Ijarah Sukuk

Bank Negara Malaysia launched the first Bank Negara Malaysia Sukuk Ijarah on the 16th February 2006, with an issue size of US$107.54 million (RM400 million).

Subsequent issues of this instrument from the Central Bank will occur regularly, ranging from US$26.89 million (RM100 million) to US$53.77 million (RM200 million).

The Sukuk is based on the Al Ijarah concept, and the proceeds will be used to purchase Bank Negara Malaysia's assets, which will then be leased back to the bank for rental payment consideration, and will be distributed to investors as a return on a semi-annual basis.

Bank Negara stated: "the Sukuk Ijarah is expected to serve as a benchmark for other short to medium-term Islamic bonds. The introduction of Sukuk Ijarah reflects the continuous efforts by BNM to spur product innovation and the development of products to meet the diversified requirements of domestic and international investors. This will augur well for the development of a vibrant and comprehensive Islamic bond market in Malaysia. It represents part of the overall effort to promote Kuala Lumpur as an international Islamic financial hub."

UAE (Abu Dhabi)

FGB explores overseas areas

First Gulf Bank (FGB) has commissioned a team of experts to investigate potential overseas markets for the bank.

Abdulhamid Saeed, Chief Executive Officer, revealed: "We are in process of obtaining necessary permission to establish a Dh500 million capital worth real estate company, to tap the enormous potential in the booming real estate sector in the country."

The bank has recently opened an Islamic finance window under its Islamic banking division, as the popularity of Islamic financing has grown.

UAE (Dubai)

P&O: It's all over

Shareholders of British port operator Peninsular and Oriental Steam Navigation Company (P&O) have voted overwhelmingly in favour of DP World's bid to acquire the firm.

The Dubai ports company secured the support of 99.52% of P&O's shareholders for its offer of US$6.8 billion (£3.9 billion), which valued P&O stock at US$9.02 (£5.20) per share.

DP World Chairman Sultan Ahmad Bin Sulayem commented on the result: "It is a vote of confidence in our ability to manage the company."

This acquisition makes DP World the third biggest port operator in the world: "We now have 50 ports in 30 countries," Bin Sulayem said.

The Chairman also confirmed that DP World did not plan to sell off P&O's European ferries business: "The company's is in good health. We are committed to the old business plan of P&O."

Inside Islamic Finance News:

NEWS BRIEFS

UAE (Abu Dhabi)

EIB branches out

Emirates Islamic Bank (EIB) has inaugurated its second Abu Dhabi branch, and will double its branches in the UAE by end of 2006. In addition, its new brokerage subsidiary will start operations by May.

Faisal Adil, General Manager of Retail, said EIB would move aggressively to ensure its place in the UAE's fast-growing Islamic segment: "The demand for Islamic banking is growing and after our bank's conversion from Middle East Bank, we have not launched many Islamic products and services. This will be offered in 2006 and beyond."

UAE's Central Bank gave EIB approval to set up a brokerage company with an initial capital of US$2.72 million (Dh10 million). "Within three months the brokerage subsidiary will become operational. We are approaching the Dubai Financial Market and the Abu Dhabi Securities Market and the stocks authority for the necessary measures to be taken."

INDIA

Bank of Baroda moves into Gulf

India's Bank of Baroda (BoB) plans to expand overseas, especially into the Gulf countries of Kuwait, Saudi Arabia, Bahrain and Qatar. Islamic banking may well form a part of this strategy.

Currently the bank operates in 21 countries through its 59 overseas offices. The bank also has a joint venture in Zambia, with nine branches. In the Gulf, the bank has six branches in UAE and three in Oman.

BAHRAIN

Huge response to Al Salam IPO

It is believed that Al Salam Bank's IPO would be several times over-subscribed when it closed for public subscription on Sunday 19th February (the allotment announcement date is set for the 12th March).

Receiving banks reported a huge investor interest at accepting desks and submissions of applications for share allotment.

The IPO offers 35% of the bank's paid up capital in the form of 42 million ordinary shares to individual and institutional investors. It will raise US$111.45 million (BD42 million, Dh409.579 million) through minimum investor subscriptions of 1,000 shares.

Mohamed Ali Alabbar, Chairman of the Founders Committee of Al Salam Bank, commented: "Investor enthusiasm for IPOs of companies with good credentials and prospects is strong. Their interest in our IPO is heartening and augurs well for the future of the rapidly expanding Islamic finance industry in the region."

INDONESIA

Funding for Jakarta's monorail?

Despite reports last week that Dubai Islamic Bank (DIB) had agreed to fund the Indonesian capital's first monorail project, providing US$500 million in finance, the bank has since denied this.

Dubai Islamic Bank issued a statement saying: "The DIB clarifies that it has made no decision or commitment to finance or arrange financing for the mentioned project."

NEWS BRIEFS

MALAYSIA

KFH investment focused

Kuwait Finance House (Malaysia) (KFHM), one of the three foreign Islamic banks licensed to provide Islamic banking products and services in Malaysia, will concentrate on its investment banking and fund management business in the future.

Executive Director, K. Salman Younis, revealed: "We will increase our focus on investment banking and fund management. These products will be rolled out in the next three to six months including more products on the retail side."

Salman also commented: "Malaysia is chosen due to its strategic location and proximity within the region, making it easier for KFHMB to cover important markets from Malaysia rather than Kuwait."

MALAYSIA

Global acceptance for Islamic products needed

The introduction of products that are universally compliant and globally accepted should be the focus of the Islamic banking and finance industry, says Hong Leong Islamic Bank (HLIB)'s Managing Director, Daud Vicary Abdullah, adding that players should offer more innovative reinvented products to compete in the global marketplace.

He pointed out that it was important for the Islamic financial world to offer customer-oriented products by listening to their needs. "Viewing the products as an attractive form of financial intermediation, the customers, especially the non-Muslims, are more interested to get good services as well as getting a value proposition from the products," Daud said, stressing that there was always room for improvement in the products and delivery services when asked about the quality of the current products.

He also called on Islamic financial service providers to benchmark themselves against other players: "To be truly competitive in the global market, you need to benchmark against the best. Not necessarily against the best Islamic bank, but against the best bank that offers good customer services and products," he added.

SOUTH AFRICA

Standard Bank in DIFC

The Dubai Financial Services Authority has granted a licence to South Africa-based Standard Bank to operate within the Dubai International Finance Centre (DIFC).

Standard Bank is the international investment banking subsidiary of the Standard Bank Group, and hopes to build on its position in the regional gold markets and in Islamic finance. In May 2005 Standard Bank launched a US$200 million Gold Sukuk DMCC.

KUWAIT

New investment fund

The Kuwaiti National Investment Company (NIC) will float an industrial resources and oil services fund for investment in Shariah compliant Kuwaiti and Gulf companies, with a forecast return of 15%–18%.

Subscription is open to all nationalities; the minimum investment is 10,000 units (at US$3.42 (KD1) per unit); the subscription commission is 2% and the annual fee is 1%; and profits will be distributed to shareholders on bi-annual basis.

UAE (Dubai)

DIB Islamic credit card

Dubai Islamic Bank (DIB) has launched its first Islamic credit card with the support of Card Tech, a UK-based bank card systems provider and processor.

The new Al Islami Credit Card, available in Visa Classic, Gold, Gold Executive and Platinum, will provide DIB customers with all the benefits of a conventional credit card whilst ensuring that all payments and repayments are fully compliant with Islamic Shariah principles.

SAUDI ARABIA

Islamic hedging deal sealed

SABB Bank has signed the first Shariah compliant deal hedging lending rates with Fawaz Al Hokair & Co.

Under the deal SABB will protect Al Hokair against the possible rise of lending rates. This is the first Islamic deal of its kind globally, and reflects the flexibility of Islamic banking to respond to modern financial requirements.

SABB has recently launched Islamic financial derivatives in partnership with HSBC.

MALAYSIA

Prinsiptek Islamic papers

The Securities Commission has approved Prinsiptek's plan to issue Murabahah Commercial Papers and Medium-Term Notes with a nominal value of US$21.5 million (RM80 million).

Proceeds from the issuance of Islamic notes will be used to repay or refinance bank borrowings and for working capital.

MALAYSIA

Saudi bank's Malaysian plans

Saudi Arabia's former Al Rajhi Banking and Investment Corp, which has changed its name to Al Rajhi, has announced plans to open 50 branches in Malaysia within five years, starting in the second quarter of this year.

Al Rajhi – the only Saudi Islamic bank licensed to operate in Malaysia – will offer retail and corporate products such as car and real estate financing.

Malaysia has also awarded Islamic banking licences to Kuwait Finance House and a consortium headed by Qatar Islamic Bank.

UAE (Abu Dhabi)

EIB depositors get good returns

Emirates Islamic Bank (EIB) announced an increased return of 6.3% on a two-year term deposit in the final quarter of 2005, from 3.88% in the corresponding quarter previously. The return is considered to be the highest declared by banks in the UAE.

As for its savings account holders, the bank also declared an increased return of 1% to 2.8% in the fourth quarter of 2005 – the profits were credited to customers' accounts on the 17th January.

These higher returns are a result of a substantial increase in deposits placed with the bank, which have risen from US$334.88 million (Dh1.23 billion) to US$977.4 million (Dh3.59 billion) – a 200% growth over a period of 12 months.

NEWS BRIEFS

BAHRAIN

Groundbreaking new fund from VCBank

New Bahrain-based institution VCBank will launch its first US$250 million fund next month, in partnership with US private investment firm Global Emerging Markets.

VCBank, which aims to become the world's first Islamic venture capital bank, plans to raise US$100 million in America and Europe for investment in Middle Eastern small and medium-sized enterprises.

UAE (Dubai)

iHilal admits equity partners

The Board of Directors of iHilal Financial Services, the Islamic financial services company focused on sourcing, structuring, and distributing financial products, has admitted two new shareholders – Baghlaf Holding Group and Al Amoudi Exchange. Each new shareholder will own 25% of iHilal's post-capital increase, with Rasmala Investments Holdings retaining 75% of the shareholding.

KUWAIT

National Investments fund

Kuwait's National Investments Company has launched a US$342 million Islamic fund to invest in Gulf equities – both listed and unlisted. The fund closes on the 9th March. Minimum subscription is US$34,240 (KD10,000) and the projected return of the fund from investment is 15%–18%.

UAE (Dubai)

Dubai Islamic Bank buys MNG

Dubai Islamic Bank has purchased Turkish-owned MNG Bank for US$160 million.

Dubai Islamic Bank, which opened its first branch in Turkey last year, enjoyed a 130% increase in net profit in 2005.

MALAYSIA

Islamic finance seminar in London

The Islamic Financial Services Board (IFSB), the Islamic Development Bank and the Asian Development Bank will host the 2nd seminar on legal issues in the Islamic financial services industry: "Towards an Effective Legal Framework for Islamic Finance: Asset Securitization and Insolvency." The seminar will be held on the 14th–15th March 2006 at The Landmark London Hotel, London.

The IFSB's Secretary-General, Professor Rifaat Ahmed Abdel Karim, said: "The seminar highlights a current and relevant concern among Islamic financial industry players – legal risks of asset securitization and insolvency which need to be identified and managed to ensure both compliance with Shariah principles and proper risk management. Inevitably, supporting sectors such as regulators and legal practitioners also need to be well-versed and informed of these risks."

Further information can be obtained from http://www.ifsb.org/landmark.

MALAYSIA

New Islamic fund from Public Mutual

Public Mutual, the largest private unit trust company in Malaysia, launched the Public Islamic Dividend Fund (PIDF) at an issue price of US$0.067 (RM0.25) per unit. Free units of 1% will be given away during the offer period from the 14th February to the 6th March 2006.

The PIDF – which has an approved fund size of two million units – seeks to provide annual income by investing in a portfolio of Shariah compliant stocks. Public Mutual's Chief Executive Officer Lam Kam Yin stated that PIDF is suitable for both Employees Provident Fund and cash investors who are moderate in risk reward profile.

He commented: "It is timely for PIDF to be launched as the Malaysian stock market's current gross dividend yield of 4.2% is the highest gross dividend yield registered in the past seven years."

JORDAN

Jordan Islamic Bank to raise capital

Jordan Islamic Bank's board of directors voted to raise the bank's capital – through distributing a 25% bonus share from the retained earnings and/or other reserves equivalent to a total of 10 million shares – from US$56.46 million (JD40 million) shares to US$84.69 million (JD60 million) shares.

The board also decided to transfer the 2005 profit to the retained earnings account.

UAE

Deyaar profits soar

Real estate developer Deyaar has reported a net profit increase of 92% to US$38.11 million (Dh140 million) for the year 2005.

Zack Shahin, CEO of Deyaar, commented: "2005 was a very successful year for us, both in terms of expanding our client base with the launch of several mega projects and with regard to the financial performance of the company. A 92% increase in profits is indeed a commendable achievement and we are confident of maintaining this momentum in the coming years."

NEWS BRIEFS

BAHRAIN

Record profits for Arcapita

Arcapita Bank's net income leapt 48% to US$104.3 million for the year ending on the 31st December 2005.

The Bahrain-based bank said that performance in corporate investment, real estate investment and asset-based investment all remained strong, generating a total operating income of US$237 million, an increase of 38% on 2004.

Over the last eight years, Arcapita's balance sheet has grown to US$1.9 billion, as at the 31st December 2005.

QATAR

QREIC package launched

An Islamic financing arrangement involving a Sukuk issue and a syndicated Islamic facility has been launched by Qatar National Bank (QNB) and Qatar Real Estate Investment Company (QREIC).

QNB and its subsidiary QNB Al Islamic are mandated lead arrangers for the package, which is worth US$375 million (QR1.368 billion). The QREIC will utilize the proceeds to develop projects in Qatar.

The Sukuk, which is the first to be issued by a Qatari corporate entity, will be jointly arranged by Dubai Islamic Bank, Gulf International Bank and Standard Chartered Bank.

MALAYSIA

Joint Islamic funds in the pipeline

Saudi company SIRAJ Capital has joined up with Johor Corp (JCorp) of Malaysia to develop and launch US$500 million worth of Shariah compliant investment funds in the two countries.

The companies will jointly launch a real estate investment trust (REIT), which will focus on real estate investments in tourism, education, property, industrial and technology parks. In addition they will launch a regional private equity investment fund (RUIF) to invest in private equity sectors such as palm oil, bio-diesel and the oil and gas industry. Both funds will have an investment size of US$250 million.

MALAYSIA

Southern Bank rejects "hostile" bid

Southern Bank has rejected a US$1.7 billion (RM6.35 billion) takeover offer from Bumiputra-Commerce Holdings (BCH), which was believed to have hostile implications and has asked the Securities Commission to rule that BCH's offer was prohibited action, contrary to the Malaysian Code on Take-Overs and Mergers 1998.

"After thorough deliberations, the board has unanimously rejected the unsolicited business offer, which has hostile implications, on the basis that it fundamentally undervalues Southern Bank and is materially inadequate from a financial and business point of view. At a 1% premium to the last traded price of Southern Bank shares on the 13th February 2006, the current business offer does not provide adequate value to our shareholders," the bank said.

Southern Bank also stated it has already approached Bank Negara Malaysia to obtain the necessary approval to enter into negotiations with another major local financial institution. There has been intense speculation that this institution is Maybank, although the bank has denied it is in negotiations with any financial institution.

PHILIPPINES

Diverse interest in Islamic bank

An unnamed group of Malaysian investors has made an offer to acquire "lock, stock and barrel" the state-owned Al Amanah Islamic Investment Bank of the Philippines.

Islamic bankers in Saudi Arabia, Kuwait and Qatar have also expressed interest in taking over the ailing bank.

The Department of Finance will auction off the bank through competitive tenders in August. Potential bidders must have submitted their letters of intent to the bank's bids and awards committee by the 22nd February.

The successful bidder will take on the bank's almost US$9.65 million (PHP500 million) in liabilities, US$135,167 million (PHP7 million) in bad loans and US$617,909 million (PHP32 million) in foreclosed assets.

NEWS BRIEFS

BAHRAIN

Ithmaar Bank's strategic partners

Shamil Bank has been named as the lead issue manager and financial advisor and KPMG is co-financial advisor for the Initial Public Offer (IPO) of the Bahrain-based Ithmaar Bank. The bank has also appointed Global Investment House, Amwal, Abraaj Capital, BBK and Bahrain Pension Fund as underwriters.

Global Investment House has been appointed as the co-manager and listing advisor, while Shamil Bank and BBK will act as the receiving banks for the IPO.

One of the largest IPOs in Bahrain, the Ithmaar IPO will offer 150 million shares at a premium to the public and the proceeds will be partly utilized to recapitalize the bank's subsidiaries and affiliate companies.

In another significant development, Ithmaar Bank also signed a US$100 million Mudarabah agreement with Shamil Bank.

SAUDI ARABIA

New Shariah fund from NCB

Saudi Arabia's National Commercial Bank (NCB) has launched the Al Ahli Secured Saudi Trading Equity Fund "A."

Amr Banaja, Head of Marketing for the asset management sector at NCB, said: "The new fund will invest in Shariah compliant stocks listed on the Saudi stock market, cash, Murabahah and Murabahah funds approved by the NCB's Shariah Board." The minimum subscription is US$66,663 million (SR250,000).

NCB offers investors open-end, high-risk funds, generating long-term capital growth through investments in Shariah compliant Saudi equities.

SINGAPORE

Islamic Equity Index launch

The umbrella FTSE-SGX Shariah Index Series will be launched in Singapore at the end of February with the inaugural FTSE-SGX Asia Shariah 100 Index.

This follows the rival group's launch in Turkey in January of the Dow Jones DJIM Turkey Exchange Traded Fund in Istanbul, based on the Dow Jones Islamic Market Turkey Index, the first such equity index in Turkey and the Middle East.

SAUDI ARABIA

Binladin bridge loan

Islamic loans worth US$400 million have been secured from eight Saudi and foreign banks to finance the US$1 billion Jamrat Bridge expansion project in Mina, which is being undertaken by the Saudi Binladin Group.

The banks are Bank Albilad, Al Khaleej Bank, Samba Financial Group, National Commercial Bank, Emirates Bank, Riyad Bank, Banque Saudi Fransi and Saudi Hollandi Bank.

UAE (Dubai)

Oasis profit rise

Oasis International Leasing Company has recorded a net profit of US$7.65 million (Dh28.1 million) for the financial year of 2005, as against US$2.15 million (Dh7.9million) in the previous year, with a total revenue growth of 6% to US$50.99 million (Dh187.3 million). The company, however, decided not to pay any dividends for the year under review.

The Dubai-based company raised its capital last year to US$408.37 million (Dh1.5 billion) from US$190.57 million (Dh700 million) in order to benefit from the improving airline industry.

UAE (Dubai)

EFG Bank joins DIFC

Zurich-based EFG International, the global private banking group, announced that its subsidiary EFG Bank has been granted a licence to operate as an authorized firm from the Dubai International Financial Centre (DIFC).

Dubai's central geographic location and transparent banking regulations have led to EFG Bank locating its regional headquarters in the country.

KUWAIT

Islamic equity fund launched

Boubyan Bank and Ryada Capital have launched the Ryada Islamic Private Equity Fund to exploit investment opportunities in private companies in the GCC and MENA region.

Fuad Al-Shehab, General Manager of Investment Group at Boubyan Bank, commented: "The partnership has been developed to offer enhanced innovation-driven products that answer investor needs and market demands; the Ryada Fund provides Boubyan Bank with a platform for private equity investments in the GCC and Levant."

GCC

Gulf financial jobs soar

Banking and finance, and Islamic finance in particular, are experiencing a regional employment boom.

Recruitment website GulfTalent.com has released figures showing that during the last quarter of 2005, "banking" was the most popular keyword searched on by online jobseekers, while other popular keywords included insurance, finance, risk, compliance and Takaful.

Specialisms within Islamic banking are amongst the areas with the greatest demand–supply mismatch, along with private banking, corporate finance and compliance.

Declan Ball, Head of Human Resources at Dubai Bank, commented: "We are actively looking for product expertise in Islamic banking but the pool of good people with the required skills, as well as an understanding of customer service, is small. As all banks are fighting a war for talent, one of our approaches is to bring in people with business expertise and train them on Shariah concepts."

NEWS BRIEFS

Ratings Update

MALAYSIA

Gas District Cooling securities reaffirmed

Gas District Cooling (Putrajaya) (GDC)'s US$80.63 million (RM300 million) Al Bai Bithaman Ajil Islamic Debt Securities have been reaffirmed by Malaysia Rating Corporation (MARC) at AAAID.

The reaffirmation is based on the strength of the project and its integrated nature – due to backing from its ultimate shareholder, Petroliam Nasional. The minimal credit risk involved in the project was also taken into account.

GDC Putrajaya operates and maintains District Cooling System plants in Putrajaya to produce and supply chilled water to government premises located in Putrajaya.

Paradym Resources rated

Malaysia Rating Corporation (MARC) has affirmed the short-term (MARC-2ID) and the long-term (A-ID) rating of Paradym Resources Industries (PRI)'s Islamic Commercial Papers/Medium-Term Notes.

This reflects PRI's improved financial position and its status as a reputable manufacturer of superior quality copper products. The ratings are supported by contracts awarded by the Royal Mint of Malaysia and Bank Negara Malaysia.

PRI manufactures and sells copper rods, wires and strips for the power and telecoms industries.

Jana Niaga negative outlook

Malaysia Rating Corporation (MARC) has placed Jana Niaga's US$26.88 million (RM100 million) Murabahah Underwritten Notes Issuance Facility (MUNIF) on MARCWatch with a negative outlook.

The initial ratings are MARC-2 ID for short-term and A-ID for long-term.

The deteriorating cash flow position of the company, due to the failure of Universiti Industri Selangor to meet guaranteed rental payments, has led to this action.

MARC downgrade for Peremba Jaya

Malaysia Rating Corporation (MARC) has downgraded the long-term rating of Peremba Jaya Holdings' US$53.75 million (RM200 million) Murabahah Underwritten Notes Issuance/Murabahah Medium-Term Notes facility to A-ID. The short-term rating is affirmed at MARC-2ID.

These ratings have been placed on MARCWatch with a negative outlook, due to the group's thinning margins, tight liquidity position and high debt leverage level arising from delays in construction and high receivables outstanding from Putrajaya Holdings.

CIMB debt facilities cancelled

CIMB has fully redeemed its outstanding Commercial Papers – worth US$26.88 million (RM100 million) – and its US$161.28 million (RM600 million) Commercial Paper and Medium-Term Notes Programs.

Rating Agency Malaysia (RAM) no longer has any rating obligation on these debt facilities.

RAM revises GB3 outlook

Rating Agency Malaysia (RAM) has reaffirmed the long-term rating (AA2) for GB3's US$228.48 million (RM850 million) Senior Secured Al Bai Bithaman Ajil Bond Facility, in addition to the long-term (AA2) and short-term (P1) ratings for its US$94.08 million (RM350 million) Al Murabahah Commercial Papers/Medium-Term Notes Facility. The outlook has been revised to positive.

This upgraded rating outlook is premised on the independent power producer's good operating record to date.

RAM reaffirms Maxis

Rating Agency Malaysia (RAM) has reaffirmed the P1/AAA ratings of Maxis Communications' proposed 7-year US$134.4 million (RM500 million) Commercial Paper/Medium-Term Notes Program.

In addition, RAM reaffirmed the AAA rating of Maxis' proposed 30-year US$134.4 million (RM500 million) Medium-Term Notes. The long-term ratings have a stable outlook.

Maxis is the dominant player in the local mobile telecommunications market and has continued to perform well within the competitive industry.

Ace rating reaffirmed

Malaysia Rating Corporation (MARC) has affirmed the rating of Ace Polymers' US$18.82 million (RM70 million) Bai Bithaman Ajil Islamic Debt Securities (BaIDS) at AID.

This affirmation is based on Ace's status as a Tier-1 supplier to the local automotive industry; improving financials; and an issue structure that prioritizes payments relating to the BaIDS over operating expenses. Moderating the rating, however, is the company's high debt leverage position; its exposure to the performance of the national carmakers; and the vulnerability of the local automotive industry to economic cycles.

MARC reaffirmation for MHS Aviation

Malaysia Rating Corporation (MARC) has reaffirmed MHS Aviation's US$16.113 million (RM60 million) Al Bai Bithaman Ajil Islamic Debt Securities (BaIDS) at AAID and the company's Junior Notes at A+ID.

This reaffirmation mirrors MHS Aviation's dominant position in the provision of aviation services to the oil and gas industry, in addition to its favourable outlook and strong cash flow protection to the bondholders, derived from the substantial contractual revenues.

Petronas Fertilizer BaIDS reaffirmed

Malaysia Rating Corporation (MARC) has reaffirmed the long-term rating of PETRONAS Fertilizer's US$201.42 million (RM750 million) Al Bai Bithaman Ajil Islamic Debt Securities (BaIDS) at AAAID(s).

This is based upon the support provided by PETRONAS Fertilizer's holding company – PETRONAS – as well as the company's strong financial profile. PETRONAS Fertilizer has a 20-year Gas Supply Agreement with PETRONAS, which ensures a continuous supply of natural gas at fixed prices.

NEWS BRIEFS

Ratings Update

MALAYSIA *(continued...)*

MARC reaffirms Tenaga Nasional ratings

The ratings of Tenaga Nasional's private debt securities have been reaffirmed by Malaysia Rating Corporation (MARC) as follows:

- US$402.78 million (RM1.5 billion) Murabahah Commercial Papers and Murabahah Medium-Term Notes – MARC-1ID/AA+ID.
- US$537.03 million (RM2 billion) Al-Bai Bithaman Ajil Bonds – AA+ID.
- US$134.26 million (RM500 million) 8-year Fixed Rate Unsecured Bonds – AA+.
- US$268.52 million (RM1 billion) Al-Bai Bithaman Ajil Notes Issuance Facility – AA+ID.

The long-term rating is AA+ and the short-term rating is MARC-1; the ratings have a developing outlook pending the review of the electricity tariffs and gas price.

This reaffirmation reflects Tenaga Nasional's important role to Malaysia's economy and national security; monopoly in transmitting and distributing electricity in Malaysia; the majority government ownership; and its stable financial performance.

Kesas bribery charges

Rating Agency Malaysia (RAM) has stated that the bribery charges against the CEO of Kesas, the toll concessionaire for the 35km Shah Alam Expressway, will not alter the company's credit ratings.

These ratings stand at AA3 for the company's US$214.81 million (RM800 million) Al Bai Bithaman Ajil Islamic Debt Securities and AA3/P1 for its US$26.88 million (RM100 million) Murabahah Underwritten Notes Issuance Facility/Islamic Medium-Term Notes.

Ahmad Kamaruzaman Abdullah has been charged with accepting bribes worth US$131,847 million (RM491,000) for two firms to be given a consulting role for Kesas' projects. He has been suspended indefinitely by the Board of Directors.

UAE (Dubai)

Amlak Finance outlook stable

Amlak Finance has been given corporate ratings of BBB long-term and A3 short-term, with a stable outlook, by Capital Intelligence.

Factors influencing this rating include: Amlak's strong growth and growing profits over the last two years; excellent asset quality; low risk credit exposure; the Ijarah financing structure; and its financially strong controlling shareholder – Emaar Properties.

UAE (Sharjah)

Ratings rise for Sharjah Islamic Bank

Capital Intelligence has upgraded the foreign currency long-term and the financial strength ratings of Sharjah Islamic Bank from BBB- to BBB. The short-term rating of A3 and the support rating of 3 have been maintained. The outlook is positive.

This upgrade is premised on the company's recent substantial capital increase from US$191.66 million (Dh704 million) to US$556.5 million (Dh2.044 billion); its move into investment banking; a swiftly growing balance sheet; improved profitability; and stringent financing policies.

UAE (Dubai)

DIB savings scheme launched

Al Islami Savings Scheme, a new plan aimed at achieving capital appreciation through investment in a portfolio of equities from the Dow Jones Islamic Market Indices, in addition to income generating deposits with Dubai Islamic Bank (DIB), has been launched by the bank.

The scheme has a five-year investment term, extendable for an extra five years, and encourages investors to save as little as US$272 (Dh1,000) per month with a US$2,722 (Dh10,000) initial investment.

QATAR

Al Rayan IPO closed

The Initial Public Offering (IPO) of Al Rayan Bank closed more than six times over-subscribed, having raised in excess of QR14.2 billion in subscriptions, on the 29th January. This may mean that this is the largest ever pan-GCC IPO in both the number of applicants and the capital sought.

Al Rayan Bank had floated 412.5 million of its shares for the IPO at a nominal value of US$2.75 (QR10) per share: the capital of Al Rayan Bank being US$2.06 billion (QR7.5 billion), distributed through 750 million shares. More than 780,000 applications were received from all GCC countries.

UAE (Sharjah)

Sharjah Islamic auto finance

The Sharjah Islamic Bank has launched vehicle finance offering a 3.75% profit rate and no salary transfer requirement.

There is a 90-day grace period, an 100% insurance finance option and repayment in up to 60 months.

UAE (Dubai)

Dubai Bank to go Islamic?

Dubai Bank has reported a 25-fold increase in profits for 2005 to US$27.99 million (Dh102.8 million).

Dubai Bank's CEO Ziad Makkawi said that the bank has yet to apply for a licence to convert to a fully fledged Islamic bank, but also said: "2006 will also be the year where we position ourselves to meet the growing demand for Shariah compliant products and services."

Dubai Bank also plans to double its capital to US$272.26 million (Dh1 billion) via a rights issue this year, the proceeds of which will be used to expand the existing business, open up new business lines and venture into new markets.

INDUSTRY REPORT

Enhancing Financial Reporting and Transparency: Keys to the Future of Islamic Finance

By Anouar Hassoune and Farouk Soussa

It is widely acknowledged that there is no single definition of Islamic finance. Different schools of thought, heterogeneous historical legacies, various degrees of flexibility, and even some intellectual competition have meant a uniform, coherent, and harmonized Shariah compliant financial code has yet to emerge. In the context of the growing need for transparent and full disclosure, one of the three most important elements of the new capital adequacy accord of the Bank for International Settlements, this raises a number of issues. These will have to be addressed if Islamic finance is to continue progress toward acceptance by the international financial community.

This heterogeneity of approaches is reflected in the way Islamic financial institutions (IFIs) prepare and communicate their accounts. Although many of them apply IFRS, these are minimal standards that, alone, are insufficient to guarantee comparability of accounts across the Islamic financial industry. This article expresses the view of Standard & Poor's Ratings Services that the standardization of financial reporting is a key challenge for the rapidly growing Islamic finance industry, in order to avoid fragmentation and ultimately ghettoization at a time when Shariah compliant investment vehicles, as an asset class, are coming of age.

Standardization is of little value without disclosure. Although the rules of financial reporting must be the same across the board for the sake of comparability, legibility, and efficiency in interpreting numbers from the investment side, disclosure is more about defeating the culture of excessive financial secrecy. Apart from sensitive, non-public information, IFIs, like any other issuer of Islamic financial obligations, would benefit from greater disclosure by, for example, providing as much information as possible in annual reports and other communications with stakeholders. Even in the case of sensitive information, the significance of non-disclosure can be reduced through greater use of third parties such as rating agencies. Their position as go-betweens allows them to include sensitive information in their credit analysis, which is then signalled to markets via a rating. This article also examines the extent to which financial disclosure still requires development in the Islamic finance industry, although this is a fact of life in many emerging markets, and not specific to IFIs.

Clarity, innovation, and education of markets are also required. Islamic finance, although greatly resembling conventional finance in many respects, particularly in the risks inherent to Shariah compliant investment vehicles, also has some idiosyncrasies, which can be difficult for non-specialists to understand. The concepts often require clarification and explanation, particularly because Islamic finance involves jargon that is not easily accessible or familiar to a wide range of analysts and investors. This article also examines some of these areas.

The key challenge: standardizing Islamic financial reporting

The positive approach: diagnosis

IFIs operate in various countries and regions and tend not to speak the same financial language. They have not adopted a single financial reporting framework, and it is difficult, without microanalysis of their accounts, to reconcile the various pieces of information into a single comparable set. IFRS constitutes the only financial reporting framework adopted that has vague global recognition and could help cross-border comparability of financial reports, but IFIs have yet to adopt it across the board. One constraint comes from domestic regulation: in each country, the Central Bank is responsible for designing a reporting framework and selecting the standards applicable in the banking system.

Accounting standards applied by Islamic banks

Not only do the differences among national accounting standards create heterogeneity in financial reporting, but IFRS itself might also be interpreted differently from one banking system to another. IFRS is better suited to conventional financial activities, and is incapable of capturing all the subtleties and specificities of Islamic banking and translating them into a shared language. Islamic banking and finance jargon, reflecting the specific nature of Islamic contracts, does not easily lend itself to standards that take the perspective of the economic nature of any banking transaction (such as loans, investments, placements, and fixed assets), rather than its contractual aspect (such as Ijarah, Istisnah, Murabahah, and Musharakah), as is the case in Islamic finance.

In addition, local regulators might impose a number of reporting rules that conflict with IFRS (such as the recognition and accounting of general provisions, forbidden under IFRS), which prevents strict compliance with international guidelines. Divergent interpretations of IFRS might also cause inconsistency across countries. Kuwait Finance House (KFH, A-/Stable/A-2) and Dubai Islamic Bank (DIB) both apply IFRS, for example. KFH, however, recognizes IAS 39-related fair value adjustments on its available-for-sale portfolio on the liability side, but not in equity, unlike conventional banks. DIB recognizes these adjustments directly through its income statement, and not in equity. Another example is the treatment of distributions to profit-sharing investment account holders (a class of depositors). Under IFRS, some banks, such as (Al Rajhi, A-/Stable/A-2), deduct such distributions from operating revenues to calculate net operating income, whereas others, like DIB and KFH, compute an operating income before distribution to these depositors, which, once deducted, leads to net profit.

Financial reporting standards specific to IFIs exist, but are not consistently and systematically implemented across countries. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, see the subsection below) has developed these standards, which are comprehensive in the sense that they constitute an autonomous financial reporting system. They are comparable with and very close to IFRS, and the Financial Accounting Standards (FAS) issued by AAOIFI do not materially conflict with IFRS in a general sense. In certain instances they do, however, creating some confusion regarding comparability. IFIs that comply with AAOIFI's standards are neither entirely comparable with IFIs that do not use them, nor with conventional peers in their own domestic market. Islamic banks in Bahrain, for example, have adopted AAOIFI's standards, and remain the only IFIs in the Gulf to do so. Although this contributes to the standardization of Bahraini IFIs' financial reporting, it also creates heterogeneity in the system because conventional banks are using IFRS.

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Enhancing Financial Reporting and Transparency: Keys to the Future of Islamic Finance *(continued...)*

AAOIFI Financial Accounting Standards: a brief overview

AAOIFI's FAS constitute an autonomous and almost comprehensive accounting system. AAOIFI is "an Islamic international autonomous non-profit making corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions." Established in 1990 in Algiers, AAOIFI was registered in 1991 in Bahrain. Its website address is www.aaoifi.com.

AAOIFI states that:

"(a) all IFIs should apply the standards issued by AAOIFI, where such standards are available;
(b) when there are no specific standards, the IFI may use standards other than those issued by AAOIFI as deemed appropriate, which do not contravene the Shariah rules and principles;
(c) should the requirements of such standards mentioned in paragraph (b) be in conflict with Shariah rules and principles, and the institution is compelled to use those standards, a disclosure must be made of the point of conflict while adhering to the requirements of a Shariah necessity;
(d) whenever AAOIFI issues standards that cover the cases in paragraphs (b) and (c), the IFI must apply the new standards."

AAOIFI also states "that the existing international standards [are] inadequate to cater for [the Islamic financial industry's] needs. AAOIFI has issued 56 standards on accounting, auditing, governance, ethical, and Shariah standards, including a statement on capital adequacy."

The normative approach: recommendations

A dual standard option would be the most comprehensive and fruitful approach for financial reporting. Such an approach involves IFIs applying both IFRS and AAOIFI standards, depending on the type of activity being reported. For those aspects of IFIs' banking operations that do not differ substantially from those of conventional banks, such as investments, inter-bank placements, current account administration, and capital policies, IFRS should be applied. The benefit of this would be enhanced comparability of Islamic banks with their conventional peers, not only domestically but internationally.

For Islamic activities where IFRS standards are not adequately adaptable, however, such as Musharakahs, Murabahahs, Istisnahs (but not Ijarah contracts, comparable to leasing contracts), or unrestricted profit-sharing investment accounts (PSIAs), AAOIFI-based treatments should be applied under one single standardized set of accounting captions. For asset contracts, such captions should be disclosed as if these were loan equivalents, to facilitate their comparison with conventional banks' loan portfolios. For liability contracts, unrestricted PSIAs should be disclosed as if they were comparable with time deposits. A uniform accounting treatment of IFI-specific operations would make all IFIs globally comparable.

The dual standard approach therefore reconciles the comparability principles across the board, meaning globally between IFIs, and between IFIs and their conventional peers. Whenever IFRS and AAOIFI standards are both applicable but conflicting (in the treatment of leasing or Ijarah contracts, for example), IFRS should be given priority. This is equivalent to saying that IFRS should be applied by default, but in those instances where Islamic activities render it inapplicable, AAOIFI FAS should be used. Regulators would ultimately be responsible for making both sets of standards compatible, while ensuring that any distortion from conventional banks' financial reporting is minimized. The other option would be to consider AAOIFI FAS as the standard applicable to IFIs by default, and IFRS as applicable where no AAOIFI standard is available (this is AAOIFI's position).

Even when national GAAP are applied by IFIs, a form of reconciliation with the dual standard approach should be performed and disclosed. Some IFIs are obliged to provide financial reports under their respective national GAAP, according to their regulatory guidelines. Such a situation does not prevent them from reconciling national GAAP with IFRS. The global investment community and other foreign stakeholders would find it useful to get the same types of information under the IFRS format, augmented by AAOIFI rules. Although this may be costly and time consuming, IFRS is the preferred accounting and reporting language in a globalized economy that values standardization and comparability highly. IFIs should be sensitive to the investor community's needs and appetite for new asset classes, and start performing the reconciliation exercise from local GAAP to the dual-standard methodology in order to meet that demand.

Setting rules for financial reporting and applying them is a necessary but insufficient condition for enhancing transparency. Accounting and financial reporting standards simply constitute a minimal framework to relate to stakeholders the complex affairs of IFIs, and businesses more generally. As a general principle, substance should always prevail over form to enhance transparency, and in the case of Islamic banking and finance, where additional complexity stems from the specific and largely unfamiliar nature of the Shariah compliant model, disclosure should reach a level above the practice judged minimal by investment professionals.

Financial disclosure practices among IFIs: still short of international best practice

The positive approach: diagnosis

IFIs are mainly active in emerging markets, which generally have low financial disclosure. Under the prevailing regulations in most emerging markets, disclosure obligations are minimal, and compare unfavourably with more disintermediated, mature markets. With limited pressure from the investor community, IFIs and conventional banks alike tend to include limited information over and above the minimum compulsory data and qualitative comments in the notes attached to financial reports. This is more problematic as far as IFIs are concerned because the economic mechanisms hidden behind their published accounts may be less familiar and more complex than those of their conventional counterparts, and would benefit from greater explanation, clarity, and detail.

Several key pieces of information, either specific to IFIs or to the system as a whole, are not included in published annual reports. For example, for many years a number of Islamic banks, such as KFH, did not disclose figures on non-performing assets, capital adequacy ratios, or details on their investment portfolios, particularly in real estate. IFIs also tend not to disclose the way they remunerate PSIAs: public information on the mechanisms used, and on the rates paid is generally either non-existent or too general to be immediately usable. Furthermore, the jargon used by Islamic banks in their financial reporting documents is sometimes confusing for outsiders and non-specialists. Al Rajhi, for example, discloses under "investments," a line called "mutajara", which might be misleading because it may look like a loan, whereas it is a placement with the Central Bank, acting as a fixed income portfolio for liquidity purposes.

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Enhancing Financial Reporting and Transparency: Keys to the Future of Islamic Finance *(continued...)*

Disclosure is more about providing investors with as much high quality public information as possible than merely sticking to minimum reporting standards. Enhanced transparency means making the analysis of the numbers by outside stakeholders easier. Minimal regulatory requirements might not be enough, therefore. That is why precise supplemental qualitative information, either in the notes or in the management discussion and analysis, are extremely useful for annual reports' readers. Such qualitative highlights give flavour to the numbers and help the outside world extract more meaning than would be possible from the raw figures alone. Valuations by equity analysts, creditworthiness assessments by rating agencies, and risk pricing by any counterparty or correspondent would consequently become more accurate, and improve asset allocation.

> "Islamic financial institutions must strive to exceed regional standards of disclosure, and close the gap that separates them from international best practice. "

Most Islamic banks have not reached the level where public information available in management reports and the notes to financial statements provide a clear and transparent picture of their business dynamics. Educated guesses by outsiders might be easier for conventional financial institutions because many analysts are more familiar with their business model. By contrast, Islamic banking and finance use a fairly young, narrow, unfamiliar, complex, and specific model, and extracting a genuine and exploitable sense from the numbers IFIs usually provide is more challenging. Enhancing disclosure and greater transparency would lower the entry costs of outside analysts into the Islamic finance world, and would make the entire industry more accessible, transparent, and ultimately attractive to investors. The more disclosed in public reports, the greater the benefit. Obstacles to disclosing more are low because much of the undisclosed information is not sensitive per se. It includes: details on asset quality and PSIAs; exposures on real estate and capital markets; enhanced data on capital adequacy ratios; and off-balance sheet items. These figures are not sensitive, and are widely disclosed in more mature markets.

The significance of non-disclosure of sensitive information can be reduced through greater use of third parties such as rating agencies. This argument has a long tradition in the academic literature, and considers rating agencies to be a signalling mechanism to markets where the underlying information is of a proprietary or sensitive nature. This derives from rating agencies' unique position as disinterested providers of quantitative and qualitative analysis of an entity to markets, with access to private information and key management. As part of the rating agreement, sensitive information is never disclosed to the public. Insofar as this information would have an impact on the market's assessment of the creditworthiness of an institution, however, the credit rating provided to markets reduces the significance of the non-disclosure because it incorporates that impact without revealing the information itself. Standard & Poor's rates three IFIs, including the (AAA/Stable/A-1+).

Perversely, the strict application of IFRS, for example in Saudi Arabia and the UAE, sometimes reduces the amount of information available on IFIs. In particular, under IFRS, PSIAs are considered customer deposits, even though the two terms are not exactly equivalent. Such an approximation means that readers lose the complexity inherent in any PSIA contract, in the absence of any additional (facultative) disclosure in the notes. DIB, for example, does not give any additional details about its "investment deposits" included in customer deposits, apart from the amount of profit equalization reserve set aside by the bank on behalf of PSIA holders. Here again, an outsider would not understand such a reserve without a precise knowledge of how PSIAs work in practice, or the fact that such reserves would be used to smooth returns on PSIAs if the bank's profitability was insufficient.

The normative approach: recommendations

IFIs should make their financial reports available in the public domain, along with definitions of Islamic banking specific terms. As long as Islamic finance remains on the fringes of mainstream financial activity, IFIs must endeavour to increase clarity, an important aspect of financial transparency. Widely used terms in Islamic finance, such as Murabahah, Ijarah, Mudharabah, or Musharakah need to be accompanied by only basic definitions, because exposure to these concepts is increasing through various alternative sources of information. More obscure concepts, such as Musahamah, Mutajarah, or Tawarruk, however, might be familiar to Arabic speaking stakeholders, but remain unknown to most non-specialists. In order to broaden the understanding of Islamic banking and finance, these terms should be systematically explained in greater detail.

In addition, because Islamic banking and finance are based on the cardinal principle that each and every financing transaction is backed by a tangible asset, it would enhance analysis if IFIs' Shariah compliant transaction types were subject to systematic disclosure by type of underlying assets (such as real estate, car, manufactured goods, shares, and commodities). Islamic banks should also publish in their accounts the basic key principles of Islamic banking, like the ban on interest, profit sharing, the ban of "gharar" (uncertainty), and the financing of tangible assets rather than pure lending. This would make annual reports published by IFIs fully autonomous documents, contributing to easing readers' access to the whole industry. This would gain the sector immediate credit for its willingness to become part of the global financial arena, not just a regional niche marketplace.

IFIs must strive to exceed regional standards of disclosure, and close the gap that separates them from international best practice. As long as it is not of a proprietary or sensitive nature, IFIs should disclose as much information to the public as possible. Because they are specialized, and constitute an expanding but still relatively tiny community in the world of global finance, the risk of being ghettoized is real. Gaining recognition on international markets often goes hand in hand with financial institutions' need to access global capital markets to raise funds, either as equity or debt. So far, IFIs have not had much need for international capital or funds, either because they are mainly domestic, or because they operate in markets structurally awash with liquidity, such as the oil producing Gulf states. It is likely, however, that a time will come when IFIs will wish to access international markets, and at that time global investors will need to learn about Islamic finance and its subtleties. In anticipation of investors' appetite for detailed knowledge of issuers' profiles, the most effective option is to start well in advance to educate capital markets in Islamic banking and finance.

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Before engaging in publicity and education campaigns (discussed below), educating the market about Islamic finance starts with getting close to best international practice in terms of disclosure. The best way to proceed is to benchmark IFIs' disclosure practices, not so much against regional conventional peers, but against first class global issuers. Benchmarking ambitions must be high because they contribute to enhancing one of the key aspects of corporate governance, accountability. This means reflecting in published financial reports as much of the economic substance of the institution as possible, through transparent, consistent, comprehensive, detailed, fair, and honest communication to the outside world. Increased transparency and disclosure would also contribute to further market discipline, an important aspect of capital markets' self-regulation, as enshrined in the third pillar of Basel II.

Greater transparency and standardized accounting principles constitute the two main legs of enhanced financial reporting practices necessary for Islamic finance to reach the recognition it has been seeking for more than three decades. In the first decade, the overall philosophy of Islamic finance emerged, with its principles, methodologies, rules, and products. Growth and expansion followed in the 1980s and early 1990s, and the sector proved its capacity to absorb shocks and adapt. In recent years it has emerged from its infancy as a proven viable model, and an alternative to riba-based finance. As it continues to mature, the onus is on IFIs to act in a coordinated and consistent manner, despite the remaining and probably enduring differences that exist in the Muslim world. Expansion means selling the Islamic model to the global market. This is no easy task, but as long as there is demand for it, IFIs must strive to educate markets about their business.

The need for further investment in education, clarity, and communication

The positive approach: diagnosis

The Islamic finance industry has not so far fully coordinated its communication with the outside world. For decades, IFIs had limited forums in which to share knowledge for the cross-fertilization of conceptual, technical, and practical ideas. In each country, IFIs traditionally protected their expertise and franchise, all the more so because in many of these countries Islamic banks were in a situation of de facto monopoly or duopoly (in Saudi Arabia, Kuwait, Qatar, or the UAE, for example). In addition, the Islamic finance industry was striving to put its concepts and business practices in order, and had little interest in attracting attention.

The situation is now changing. Places where Islamic bankers and financiers can meet and discuss their field of expertise are countless. Islamic bankers' associations are active in putting data and knowledge together: the Islamic Finance Standards Board (IFSB) in Malaysia has the support of numerous regulators in the Muslim world and outside it; the Liquidity Management Center (LMC) in Bahrain is a brainstorming club intended to discuss the conceptual and technical issue of liquidity management in Islamic banking. More coordination is still needed to project a unified and consistent image to the outside world, however. With the exception of the IFSB, which remains a club of regulators, IFIs themselves have not so far combined significant resources and efforts in shared marketing campaigns. Coordination is all the more essential because the Islamic financial industry remains fragmented, not only geographically, but also conceptually. For example, what might be considered "halal" by a Shariah board adhering to the Chafi'i school of thought in Kuala Lumpur or Jakarta might not be considered so in Riyadh or Doha, where thinking is closer to the Hanbali tradition.

There is still limited willingness to pay for the costs of publicity. So far, the bulk of IFIs have remained mainly domestic operators – with the notable exceptions of some internationalizing banks like Al Baraka Banking Group or KFH – and so they have not felt the need for global communication. Because attracting and retaining their immediate clientele are their main strategic objectives from a commercial perspective, there are very limited incentives to go for a more ambitious, probably not immediately rewarding, and far more costly publicity plan beyond the natural borders of their domestic and regional markets.

IFIs have just started to learn from global capital markets and play by their rules. As emerging market operators, IFIs have the same shareholding structures as their conventional peers. A large number of IFIs are still owned by governments and wealthy business families, with limited incentives to go public. Many IFIs are also very good at attracting retail and wholesale funding, and so incentives to raise debt on domestic, regional, or international markets are also limited, which reduces the need to open up to the outside world. This is changing, however. Islamic banking is growing rapidly (often at

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double digit rates), and such growth has to be funded at a time when equity financing is not indefinitely extendable. Islamic banks will have to resort to some sort of debt financing, through Murabahah based, long-term bank syndications or longer maturity Sukuk issues. This will probably force them to improve transparency, disclosure, and attempt to educate global market players (and particularly investors) in the specific ways of the Islamic financial industry's model.

The normative approach: recommendations

For IFIs, financial reporting standardization and enhanced disclosure go hand in hand with market education in the principles of Islamic finance. IFIs should prepare themselves for criticism and skepticism. Attracting international attention and global recognition also means efforts to strengthen the industry's discourse about itself. Such an endeavour assumes that the principles of Islamic finance (not just financial reporting and data disclosure) should be simply, consistently, precisely, and comprehensively presented and explained to the various market interlocutors of IFIs, not only in their immediate neighbourhood, but also globally. In the UK, the start of operations by the Islamic Bank of Britain (IBB) a few months ago has added more visibility, credibility, and reach to Islamic finance, but it was not easy to achieve. IBB's shareholders had not only to convince the UK regulator, the Financial Standards Authority, but also the general public, through various media. This is probably the most difficult aspect of enhancing transparency, far more time–consuming and subtle than producing fair financial statements and maximizing financial disclosure.

IFIs must accept the constraints attached to global recognition. Global capital markets will not adapt themselves to the specific nature of Islamic finance; consequently, it is IFIs' responsibility to adapt themselves to the rules, language, habits, and customs of the markets. Going public, being listed, receiving credit ratings, and disseminating as much information as possible to the marketplace will all give credit not only to individual IFIs, but also to the whole industry itself.

Credit ratings in particular constitute a very valuable instance of where, through the informational intermediation performed by rating agencies, the marketplace is given an independent and comprehensive assessment of IFIs' creditworthiness. At the same time, rating agencies that look at IFIs naturally help to educate investors about how to analyze their financial statements and the intricacies of their business model. Given their access to non-public information, rating agencies can play the role of intermediaries between a growing and maturing industry and a marketplace still unfamiliar with the complexity inherent in an alternative way of performing financial transactions.

Being listed provides equity analysts with the opportunity to value IFI stocks, and to disseminate analytical judgments to the marketplace as a complement to the credit-oriented opinions of rating agencies. As a result, not only can IFIs handle their own marketing, publicity, and education efforts, but they can also rely on professional partners (regulators, rating agencies, the media, and credit and equity analysts) to outsource some of the communication tasks necessary for enhancing the whole industry's transparency.

STANDARD & POOR'S

The authors are Primary and Secondary Credit Analysts at Standard & Poors. Anouar Hassoune can be contacted in Paris on: tel: +33 1 4420 7318, email: anouar_hassoune@standardandpoors.com. Farouk Soussa can be contacted in London on: tel: +44 20 7176 7104, email: farouk_soussa@standardandpoors.com.

MARKET REPORT

The Importance of Good Corporate Governance in Islamic Banks in Malaysia

By Elsa Satkunasingam and Bala Shanmugam

This is the first section of a two-part article on corporate governance in Malaysia. This part will examine corporate governance and Islamic banking in general, as well as looking at Malaysian Code on Corporate Governance. The second part will appear in the next issue of Islamic Finance news.

Introduction

Good corporate governance is important for all corporations, but is of especial importance to Islamic banks, as these institutions have a moral dimension to their commercial transactions.

This article will examine the extent to which Malaysian law takes cognisance of the moral aspects of the banker/customer relationship in Islamic banks. It examines whether the corporate governance rules in Malaysia sufficiently address the unique position of Islamic banks and the duty of such banks towards their customers. This article will specifically focus on Mudarabah accounts to illustrate the effect that poor corporate governance may have on the Islamic banking sector.

Islamic banks and corporate governance

The Islamic religion relates directly to all aspects of the life of a Muslim, including his wealth and finance. While there is no prohibition on the accumulation of wealth, it is considered sinful to do so at the expense of the poor. Wealth is considered a trust and a test. Failure to use it wisely, especially to alleviate the hardship of the poor, is detrimental to the person who holds that wealth.

One of the most important prohibitions against misuse of wealth is the prohibition against "riba," which is generally translated to mean "usury" or "interest." The pre-Islamic Arabs had a practice of granting loans with interest and when the debtors defaulted the interest rate was doubled, tripled or quadrupled, thus making it impossible for the economically disadvantaged to free themselves from debt. Since Islam places importance on social welfare practices, this practice was prohibited. It was also deemed to create unjustified property rights. Obtaining wealth by charging interest on loans especially to the poor and needy was considered un-Islamic as it amounted to accumulating wealth without labour at the expense of those in need. While there are differing viewpoints as to whether the term refers to usury or simple interest, it is not within the scope of this paper to discuss these matters.

Bank Islam Malaysia was established under the Islamic Banking Act 1983 (Act No 276) and was the first bank to offer services aligned to the requirements of the Shariah. The Islamic Banking Act 1983 does not have comprehensive provisions for Islamic banking. The National Shariah Advisory Council is the highest authority that can issue opinions or edicts on Islamic banking. Islamic banks are subject to the supervision of the Central Bank in Malaysia. The Act relates to the manner in which an Islamic bank can be established and managed. It does not provide for the resolution of disputes between Islamic banks and its customers. This is governed by civil law.

Islamic banks and financial markets have become sophisticated over the years and in Malaysia, these institutions co-exist with conventional institutions within the current regulatory mechanisms. The Kuala Lumpur Stock Exchange (KLSE) has introduced a system that tracks Shariah compliant stocks, while the Securities Commission has established the Islamic Capital Market Unit and the Shariah Advisory Council to assist it in regulating Islamic banks and financial institutions. The mechanisms to ensure that banks, financial institutions and corporations are Shariah compliant are numerous, but Islamic banks have no extra precautions that take into account the special and vulnerable position of depositors. Since one of the cornerstones of Islamic banking is the sharing of profit and loss, rather than the imposition of interest alone, good corporate governance is crucial to ensure that the depositors suffer no loss simply because it is easier to "fleece" them than depositors in conventional banks.

The rationale of Islamic banking

The objectives of Islamic banks are threefold. The first objective is to offer Muslims an alternative to conventional banking. The second is to achieve equitable distribution of income and wealth, and the third objective is to promote economic development. There are several views as to how these objectives can be achieved. One view sees an Islamic bank as having a socio-economic purpose. Riba is abolished and banking transactions must not be solely profit-oriented, but aimed at promoting Islam and protecting the needs of Islamic society as a whole. This model promotes the establishment of non-bank financial institutions to provide credit to small businesses and those who may find it difficult to obtain loans from more established Islamic banks. Thus this model places great responsibility upon Islamic financial institutions to achieve the three aforementioned objectives.

An alternative model views Islamic banks as commercial entities which have the responsibility of carrying out business in a manner consistent with Islamic law. The banks' main responsibility is to shareholders and depositors, and social welfare objectives are to be fulfilled by other bodies, such as the government. In Malaysia, Bank Islam Malaysia follows this model of commercial banking, probably due to the large non-Muslim population who do not view banks as instruments of social engineering. It should be noted that neither model protects depositors from the effects of bad corporate governance practices.

Islamic banks have varying types of investments, and depositors have a wide choice of services. In Malaysia, all Islamic banks and conventional banks offering Islamic banking facilities lay stress upon the fact that their activities are free of riba and in accordance with the tenets of Islam. Despite this there is some dispute as to how Islamic their services are, followed by arguments that there is no requirement for the entrepreneur to give any collateral to the bank, as the whole system is based upon trust.

The Malaysian government implicitly and unilaterally guarantees all deposits in banks in Malaysia, however it gives no written guarantee to this effect. Consumers implicitly understand that in the event that a bank invests and loses depositors' funds, the loss will have to be borne by the bank alone and the government will refund the depositors' savings, even if in only part. The conventional banking system places the risk of loss first and foremost on the shoulders of the bank and its owners, not the depositors.

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The system is slightly different with reference to Islamic banks. The principles by which Mudarabah accounts operate are different. The bank acts as mudarib and uses the funds of depositors to invest in business activities. The profits are shared between bank and depositor but the latter bears all of any losses. This is a crucial factor that illustrates how risky the position of a depositor can be. If the Malaysian government does not guarantee the deposits in Islamic banks, depositors investing in Mudarabah accounts would be exposed to high risks indeed. The results can be unfortunate where the depositors are individuals who have invested their savings in such a system.

Islamic banks sell the fact that their banking transactions are free of riba. This legitimizes their activities in the eyes of many Muslims. In Malaysia, the presence of legislation specifically governing Islamic banks, Shariah advisory councils and strong backing by a predominantly Muslim government has propelled the success of Islamic banks. Even conventional banks are offering services similar to Islamic banks. Yet there are immense unresolved problems relating to Islamic banking services, especially Mudarabah accounts.

The Mudarabah system was probably tailored to suit the early Islamic way of life when a man's integrity and character were very important because of the close-knit community that people lived in. The fabric of society was woven close enough to hold most entrepreneurs to their word to use their best endeavours and obtain profits. In addition, the society was probably predominantly Muslim and there was a common factor in that most of them accepted the tenets of Islam or other religious beliefs. The situation is vastly different today, especially in Malaysia where a considerable number of the population is not of the Muslim faith. Urbanization has resulted in the loosening of societal bonds. What is there to make entrepreneurs keep their word when obtaining funds under the Mudarabah scheme, which, if applied strictly, does not even require the entrepreneur to stake any collateral? The Mudarabah scheme, based as it is upon the concept of trust, is open to great abuse and banks now have the additional duty of acting as watchdogs to ensure that their depositors' investments are protected. Failure to protect the investors' funds will result in losses to the investor/depositor. The effect of such losses on the ordinary person could be catastrophic.

Mudarabah schemes in Islamic banks involve three parties. The depositors are investors who deposit their funds with intermediaries to finance projects put forward by entrepreneurs. The profit and loss sharing rationale in Islamic banking makes it crucial for the intermediary to monitor the activities of the entrepreneur, although the intermediary is not managing the entrepreneur's project. The monitoring is usually carried out by insisting that the entrepreneur has a complete and accurate bookkeeping system in place. The intermediary must have access at all times to the entrepreneur's accounts to inspect and keep track of the accounts. This is absolutely crucial, as technically the entrepreneur need not provide security for the financing that he has obtained. In an ideal world, the intermediaries will have the expertise to vet and select more viable projects to finance and the entrepreneur will be cooperative in giving full and fair disclosure of the accounts to the intermediary.

The intermediary, however, is rarely capable of being fully involved in this type of lending and may be at the mercy of unscrupulous borrowers. If all parties, namely the intermediary and entrepreneur, are honest and responsible, then the system will work well, barring unforeseeable circumstances that could result in losses. It would also ensure that the intermediary could halt the entrepreneur's activities in the event that the losses are above permissible levels, and still recoup some of the capital advanced by the investors. When this is added to the pool of investments, the losses may not be high and the investor may still obtain returns from other investments. This is akin to the Musharakah system.

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ISLAMIC FINANCE *News* Team

Published By: REDmoney Suite A, Level 7 Menara Angkasa Raya, Jalan Ampang, 50450 Kuala Lumpur Malaysia
Tel: +603 2143 8100
Fax: +603 2141 5033

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Editor	Frances O'Sullivan Frances.OSullivan@IslamicFinanceNews.com	Tel: +603 2143 8100
Deputy Editor	Sreerema Banoo Sreerema.Banoo@IslamicFinanceNews.com	Tel: +603 2143 8100
Senior Writer	Seelan Sakran Seelan.Sakran@IslamicFinanceNews.com	Tel: +603 2143 8100
Correspondents	Kamal Bairamov Shirene Shan	Tel: +603 2143 8100
Research Director	Shih Yan-Ting Yan-Ting.Shih@IslamicFinanceNews.com	Tel: +603 2143 8100
Newsletter Manager	Christina Morgan Christina.Morgan@IslamicFinanceNews.com	Tel: +603 2141 6025
New Business Manager	Charles Philip Charles.Phillip@IslamicFinanceNews.com	Tel: +603 2143 8100 x 13
Subscriptions Manager	Geraldine Chan Geraldine.Chan@IslamicFinanceNews.com	Tel: +603 2141 6024
Production Manager	Jeya Jeevan Jeevan@IslamicFinanceNews.com	Tel: +603 2143 8100
Marketing Manager	Zalina Zakaria Zalina.Zakaria@IslamicFinanceNews.com	Tel: +603 2141 6021
Marketing Assistants	Dhana Dorasamy Sharifah Shazana	Tel: +603 2143 8100
Administration Manager	Kim Yong Kim.Yong@RedMoneyGroup.com	Tel: +603 2143 8100 x 23
Managing Director Training	Andrew Tebbutt Andrew.Tebbutt@RedMoneyGroup.com	Tel: +603 2141 6022
Sales Manager Training	Derrick Lee Derrick.Lee@RedMoneyGroup.com	Tel: +603 2143 8100 x 14
Managing Director & Publisher	Andrew Morgan Andrew.Morgan@IslamicFinanceNews.com	Tel: +603 2141 6020

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Tel: +603 2143 8100, Fax: +603 2141 5033

The Importance of Good Corporate Governance in Islamic Banks in Malaysia *(continued...)*

The crux of the matter is that much depends upon the efficiency and honesty of the intermediary and entrepreneur, but it would be near impossible to assess a person's character with any sort of finality. There is great demand for expertise in monitoring not only the books but also in projecting possible profits that can be obtained in the entrepreneur's business. However, Islamic banks in most countries lack such expertise and in cases where such expertise exists, too much time and effort is needed to evaluate the viability of each project put forward by entrepreneurs. Nevertheless, the bread and butter of banks is investment and trade financing and without this mainstay, Islamic banks cannot give depositors much return. This situation, together with the banks' lack of expertise and capacity in accurately assessing the economic viability of projects, puts them in a position where there are sufficient funds but no investment opportunities, or where banks lose the capital, which affects depositors. Of course, the argument that can be put forward is simply to obtain collateral from entrepreneurs before placing funds with them, but this results in counter-arguments about whether the transaction is masquerading as Islamic when it is really conventional.

The position of the depositors becomes more vulnerable when the intermediary who is expected to look after their investments has poor corporate governance practices and is subject to political pressure to lend to well-connected entrepreneurs.

The Malaysian Code on Corporate Governance

The problem of poor corporate governance in Malaysian companies and banks was addressed recently. The Malaysian Code of Corporate Governance was developed in March 2000 by the Working Group on Best Practices in Corporate Governance and approved by the Finance Committee on Corporate Governance. It was developed to initiate reforms of standards of corporate governance in line with international standards to enable Malaysian companies, whether based upon Islamic principles or not, to compete globally. One of the main aims of the Code is to encourage companies to have independent non-executive directors on the board. The Code makes recommendations for an independent board of directors to be appointed. This requirement is to establish a balance between executive and non-executive directors so that no one person or group can dominate the decision-making process. In addition there should be transparent procedures for the appointment of new directors to the board and all directors should submit themselves to re-election at regular intervals. The Code also reiterates the importance of an Accountability and Audit Committee, whose role is not only specified within the Code but also by the KLSE.

How does the Code improve the principles relating to corporate governance? While it merely aims to lay out broad principles of good corporate governance, companies listed with the KLSE have to state how they have applied the recommendations in their company. This would probably mean that there would be an end to domination of the board by one person or group. It should herald in a new era where corporations are more accountable to shareholders and to the public.

Part 2 of the Code lays out the best practices and among these is the recommendation that the position of Chief Executive Officer and Chairman is divided to ensure a balance of power and authority. In addition, it states that independent non-executive directors should make up at least one-third of the board's membership. Where there is a majority or significant shareholder in the company, there should be a sufficient number of non-executive directors to represent the other shareholders. More importantly, the board has to put in place a process to assess the effectiveness of the board as a whole.

The Code provides for balanced and independent financial reporting which is crucial to the management of companies. It recommends a system of internal control and states that there should be a formal and transparent arrangement to depict the relationship between the company and its auditors. The board has to establish an audit committee of at least three directors, which is chaired by an independent non-executive director. The committee should have investigative powers. The board has to devise proper corporate strategies and then evaluate whether the management of the company is carrying out the strategies properly. In addition, the board has to identify principal risks and ensure the implementation of proper systems to manage these risks. With reference to Mudarabah accounts in Islamic banks, the risk management factor is of great importance to depositors and shareholders alike.

> "The problem of poor corporate governance in Malaysian companies and banks was addressed recently by the Malaysian Code of Corporate Governance"

The Malaysian Code on Corporate Governance 2000 aims to introduce good corporate governance in companies. The most crucial factor in the Code is the independence of the board and the Chairman. The Working Group that drafted the Code stated in the explanatory notes:

> "One issue that surfaces in the Malaysian context in respect of the role of the Chairman is the almost 'too ready' acceptance of the views of the dominant voice at the meeting. There is a general unwillingness by boards to pursue debate and a perhaps over-eager desire to find a consensual resolution to issues and problems. Achieving consensus more often than not is a compromise towards the most entrenched view on the board, of sometimes a single voice rather than that of the majority of board members."

This is a very important acknowledgement by the Working Group, as the general unwillingness to engage in debate and confrontations must be overcome if the board is ever to be independent and protect the interests of the company, shareholders and creditors. The drawback though is in the definition of the term "independence," which is "independence from management and independence from a significant shareholder." It is almost as if the Working Group shied away from addressing another serious problem with corporate governance which is independence from politics.

The authors are from Monash University Malaysia.

Islamic Finance forum

During the past year we have witnessed numerous new and exciting Shariah compliant products. Quite simply, what new products and advancements do you expect we will see during the course of 2006?

SAMI MATRAJI LLM

UAE Norwich

What really marks Islamic finance products is that they are the result of a combination of various traditional Islamic transactions applied in order to construct a Shariah compliant product which is aimed to substitute a conventional financial product prohibited because it contains one or more elements of prohibition (i.e. riba, gharar). Therefore, any modern Islamic finance product is structured in a way to possess the same economic result – which is also deemed acceptable by the Shariah – as a conventional product, yet excluding all elements of prohibition.

In other words, the objective of Islamic finance is to structure a transaction that bridges western and Islamic financial systems and their divergent credit, economic, legal and cultural parameters. For example, the banking system is based on the Mudarabah and Murabahah agreements, securitization is built upon Sukuk, and project finance might combine Ijarah, Salam and Istisnah transactions.

The challenge in 2006 lies in the derivatives market, which is still poorly explored by Shariah scholars, although some attempts have been made by Deutsche Bank and other investment banks to implement derivatives prod-

PROFESSOR RODNEY WILSON

Director

University of Durham

The next year promises to be the most significant year yet for both further innovation in Islamic financial products and wider international adoption of some of the products that have already been developed.

At the retail level, the spread of new deposit facilities seems likely, notably treasury accounts based on Murabahah structures. These have been pioneered by the Islamic Bank of Britain with considerable success, and it is likely that Islamic banks in Malaysia and the Gulf will start to offer similar products in 2006.

On the retail financing side we can expect to see more home financing offered based on a diminishing Musharakah structure, comparable to that already offered by Lloyds TSB. Such partnership structures have a huge potential, especially for lower income Muslim families who in the past could only afford to rent, but who might prefer to participate in co-ownership structures that would provide them with the opportunity to acquire full ownership as their financial circumstances improve. As more countries in the Gulf extend ownership rights to expatriates, this may also help to stimulate the movement to buy rather than rent property.

At the capital markets level, significant developments can be expected in 2006.

At present there are no Shariah compliant repurchase agreements (repos), but Noriba Bank in Bahrain is trying to structure such products. These are highly significant for treasury operations. The way forward for such products is likely to be through a Salam structure, so keep reading *Islamic Finance news* to learn more about these significant developments in 2006.

2006 could also be the year when Musharakah-based Sukuk become more standardized, and this structure starts to be more widely used. Expect also to see more Shariah compliant venture capital financing as small business financing takes off in the Gulf, particularly in the UAE and Saudi Arabia. Such financing is likely to be based on diminishing Musharakah structures. Indeed, 2006 may well be the year when Musharakah finally comes of age, a welcome development for many as the industry finally starts to use structures long favoured by academic commentators.

Next Forum Question

Are present Islamic finance accounting principles and guidelines effective (and flexible) enough?

If you would like to air your views on the next Islamic Finance Forum Question, please email your response of between 100 and 300 words to Christina Morgan, Islamic Finance *news* Manager at: Christina.Morgan@IslamicFinanceNews.com before Wednesday 1st March.

UAE

First Shariah syndicate at Lloyd's

In a move thought to encourage growth in the re-Takaful industry, SALAMA Islamic Arab Insurance Company has established the first Shariah syndicate at Lloyd's of London.

The Takaful syndicate commenced trading with an initial underwriting capacity of US$72 million. It has a security rating of A, as afforded to all Lloyd's syndicates by Standard and Poor's, AM Best and Fitch.

Sheikh Khaled bin Zayed bin Saqr Al Nehayan, Chairman of SALAMA, commented: "The London insurance market is the world's leading centre for international insurance and reassurance and Lloyd's is the world's leading specialist insurance market. Nowhere is there such a concentration of specialist underwriting and broking expertise. That's why SALAMA sees this agreement as an important strategic business move that will have a fundamental impact on the growth of Takaful and re-Takaful worldwide."

"SALAMA has a proud record of being the market leader in Takaful and re-Takaful. This agreement is another first that will significantly contribute to the future profitability of the company. It will also create a unique opportunity for Takaful and re-Takaful companies to benefit from Lloyd's security."

SALAMA has also become the first UAE insurance company to allow nationals of other GCC countries to own its shares. This move followed a UAE government decision to treat GCC nationals as locals in the country's stock markets and was in line with a decision by SALAMA's shareholders to allow equity ownership to be extended to GCC nationals.

MALAYSIA

Takaful – room for expansion

Further to Bank Negara Malaysia's issuance of four new Takaful licences last month (see the last issue of Islamic Finance *news*), existing insurers have stated that the Malaysian Takaful market has room to accommodate new players.

Aminuddin Md Desa from Maybank Group Insurance Business Sector commented: "It is a positive move. Consumers will be spoilt for choice as an array of new products will be hurled into the market." This should enable Malaysia to better compete with Bahrain and other Gulf states to become a global hub for Islamic financial services.

The penetration rate for the Takaful industry remains under 6%, indicating still untapped potential, despite a recent 20% industry growth rate.

Industry players do have concerns regarding human resources issues over the next few months, as the new Takaful companies start up. There is a shortage of Shariah scholars and experts in Malaysia, which could lead to staff pinching.

INDONESIA

Takaful market to grow

The Association of Indonesian Shariah Insurance is aiming for the Takaful industry to hold a 2% market share of the Indonesian insurance industry in 2006, an increase from the 1.5% market share held in 2005.

Chairman of the Association, M. Syakir Sula, said that the higher capitalization of new insurance companies in 2006 could lead to a greater market share.

There are currently 30 Takaful and re-Takaful companies in Indonesia, with five more expected to begin operations in March. Mr Syakir predicted that there would be around ten new Takaful companies in Indonesia this year, with a higher capital base than that of the existing players.

QATAR

Doha Solidarity formed

Doha Insurance company and Bahrain-based Solidarity have signed a Memorandum of Understanding in order to form new company Doha Solidarity, to offer Solidarity's range of Takaful products in Qatar.

Solidarity's Islamic insurance and assurance products are currently marketed in most GCC countries.

Khalid Janahi, Chairman of the Executive Committee of Solidarity said: "Qatar has witnessed robust growth in the business sector over the past few years in the financial services industry and especially in Takaful products. Economic indicators show that Takaful will experience significant growth due to the increase in customer demand for Islamic financial services. Solidarity identified the increasing demand for quality, innovative and competitive Shariah compliant Takaful products in the market and set out to fill this need."

UAE (Abu Dhabi)

ADCB to expand Islamic services

Abu Dhabi Commercial Bank (ADCB) launched the "Meethaq" Shariah compliant Savings and Takaful programme, which combines both savings and Takaful benefits. It is the first Shariah compliant regular savings programme in the UAE to do so.

ADCB signed an agreement with Dubai Islamic Insurance and Reinsurance Company – AMAN – to allow the establishment of a financial portfolio that invests in 16 Islamic Shariah compliant investment funds, working along three set strategies. The minimum time period for investment is seven years.

ADCB may well launch more Islamic solutions later in the year. The Chief Executive of ADCB Eirvin Knox said: "Fulfilling its social responsibilities, and the public expectations from a leading financial institution in the region, ADCB aims to introduce more innovative Islamic financial solutions, fully manufactured by the bank, or in partnership with other financial institutions."

MALAYSIA

HSBC's Takaful plans

HSBC Insurance (Asia Pacific) Holdings, which together with Jerneh Asia and the Employees Provident Fund (EPF) of Malaysia has obtained approval from Bank Negara Malaysia to form a joint venture Takaful company in Malaysia, has expanded on its Takaful plans in the country.

HSBC Insurance will take up 49% of the equity in the new company for a consideration of US$13 million (RM49 million). Jerneh Asia will hold a 31% stake for US$8.33 million (RM31 million) and EPF will take 20%, injecting US$5.38 million (RM20 million) into the joint venture. The new company will be capitalized at US$26 million (RM100 million) and will offer a range of life and general Takaful products.

MALAYSIA

MAA high expectations from Takaful JV

Malaysia Assurance Alliance (MAA) is confident that its Takaful joint venture (with Bahrain's Solidarity) will raise between US$26.89 million and US$34.96 million (RM100 million to RM130 million) in premiums within a year of starting up.

Solidarity and MAA were granted one of the new Takaful licences last month (see the last issue of Islamic Finance *news*), which allows both organizations to extend Takaful product lines and services to the Malaysian market.

MAA's CEO Ramlan Abdul Rashid said the joint venture company would introduce at least nine Takaful products when it starts operating in three months: four family Takaful and five general Takaful.

EVENTS DIARY

Islamic Finance Singapore 2006
Hilton Hotel, Singapore
Tuesday, 21st – 22nd February 2006
Organized By: IQPC Worldwide

2nd Seminar on the Regulation of Takaful
The Andaman Langkawi, Malaysia
Thursday, 23rd – 24th February 2006
Organized By: IFSB

Hedge Funds World Middle East 2006
Madinat Jumeirah Hotel, Dubai
Monday, 6th – 8th March 2006
Organized By: Terrapinn

Globalisation of Islamic Banking & Finance
JW Marriott, Kuala Lumpur
Wednesday, 8th – 9th March 2006
Organized by: Marcus Evans

Islamic Project Financing
JW Marriott Hotel, Kuala Lumpur
Monday, 13th – 14th March 2006
Organized by: The Asia Business Forum

2nd Seminar on Legal Issues in the Islamic Financial Services Industry, "Toward An Effective Legal Framework for Islamic Finance: Asset Securitization and Insolvency"
The Landmark London Hotel, London, UK
Tuesday 14th – 15th March 2006
Organized by: IFSB

The 1st Islamic Banks & Financial Institutions Conference in Syria: "Islamic Banking's Horizions"
Le Meridien Hotel, Damascus
Monday, 13th – 14th March 2006
Organized By: Al Salam for International Conferences & Exhibitions

International Islamic Finance Forum Middle East
Dubai, UAE
Sunday, 19th – 22nd March 2006
Organized By: IIR Middle East

Securitisation World MENA 2006
The Jumeirah Beach Hotel, Dubai, UAE
Tuesday, 4th – 6th April, 2006
Organized By: Terrapinn

7th Harvard University Forum on Islamic Finance, "Integrating Islamic Finance in the Mainstream: Regulation, Standardization and Transparency"
Saturday, 22nd – 23rd April 2006
Harvard Law School, Massachusetts, USA
Organised by: Harvard Law School

STEP Arabia Conference
Emirates Tower Dubai
Tuesday, 25th – 26th April 2006
Organised by: STEP

3rd Islamic Financial Services Board Summit: Aligning the Architecture of Islamic Finance to the Evolving Industry Needs
The Phoenicia Intercontinental Hotel Beirut, Lebanon
Wednesday, 17th – 18th May 2006
Organized By: IFSB

TAKAFUL REPORT

Takaful Interview with Azman Wong Ismail

By Zakariya Othman

Fiqh al-Takaful is a new field and naturally both practitioners and Shariah scholars are still grappling with it, given the fact that Takaful came into being only two decades ago. Unlike Islamic banking, Takaful is seen to be more difficult to understand and there are issues that need to be reviewed, re-evaluated and resolved. Islamic Finance *news* talks to Azman Wong Ismail, an independent Consultant, to look into some of the issues in the General Takaful model.

One of the two categories in the General Takaful model is the Commercial Takaful model, which uses either the Mudarabah or the Wakalah model. General Takaful business in Malaysia and other parts of this region basically follows the Mudarabah model, specifically the modified Mudarabah model.

Under the pure Mudarabah model, the Takaful operator and the participant share direct investment income only and the participant is entitled to a 100% share of the surplus. However, under the modified Mudarabah model, the investment income is ploughed back into the Takaful fund and the Takaful company shares with the participant the surplus from the Takaful fund.

Having briefly explained the two models, independent Consultant Azman Wong Ismail raised his concern on the permissibility of such a modified model from the Shariah perspective.

Mudarabah is a contract between one party, known as the ra'sul mal (or capital provider), with another party, known as the mudarib (entrepreneur). The ra'sul mal provides the capital while the mudarib, on the other hand, provides the skills in a business venture. When there is a profit it is shared between them in a pre-agreed manner. A pure Mudarabah model conforms to this definition, whereby the Takaful operator is the mudarib and the participants are the capital providers.

However, the modified Mudarabah model does not conform to this definition. Under the modified Mudarabah model, no profit from the venture is shared between the operator and the participants. Instead of profit, what is shared under the modified Mudarabah model is the actual balance of the fund at the end of the Mudarabah contract period, termed as underwriting surplus, and not the surplus between the opening balance and the closing balance of the Takaful fund during the period, as profit is defined.

The issue here, having highlighted the non-conformation of the modified Mudarabah, is why this model is still being practised in this part of the world? At the same time, despite being rejected by some scholars and practitioners, especially in middle-eastern countries, no fatwa has yet been issued to prohibit the practice.

Borrowing the words of Sheikh Nizam al-Yaqubi at the International Conferences on Takaful in 1999 and 2000, Mr. Azman repeated: "If we call the modified Mudarabah by the name of Mudarabah, then we are not putting things in the right perspective."

Another issue of concern in the current general Takaful practice is the insertion of the Tabarru' elements in the contract. If it is Tabarru', then the fund does not belong to the participants, as they have willingly relinquished it. So it seems that under the current general Takaful contract, the fund belongs to neither the operator nor the participants. On the other hand, which may seem a convoluted logic to some, it belongs to both operator and participants. The issue becomes more complicated, as the next question arises is: in what proportion?

The current logic says that under the present general Takaful practice in this region, the fund does not belong to the operator since it belongs to the capital provider, and does not belong to the participant if it is Tabarru'. Then under what basis does the operator manage the fund? If it is under the presumed Wakalah principle, is it correct to assume that it is a trust fund that belongs to the community of participants and thus they should not expect any surplus?

Sheikh Yusuf al-Qardawi said:

"In order to establish a cooperative system on a sound footing in any group which desires to help its members in the event of unforeseen calamity, the following conditions must be met in regard to the money collected:

- Every member who pays his allotted share of money pays it as a donation, in the spirit of brotherhood. From this pool of donations, help is given to those who are in need.
- If any part of this money is to be invested, it should be invested in halal businesses only.
- It is not permitted to the member to donate his share on the condition that he will receive a pre-determined amount in the event of an unforeseen calamity. Rather, he will be paid an amount which will compensate his loss or part of it, depending on the resources of the group, from the pooled monies.
- What has been donated is a gift from the donor, and taking it back is haram." (Taken from the book, *Al-Islam wal-manahij al-ishtirakiyyah* (Islam and Socialism), by Muhammad al-Ghazzali, p 131.)

It is often said that the basis of the participants getting back a share of the surplus is through a counter-Tabarru'. In this respect, the operator donates back to the participant. If the operator donates back to the participant, on what basis shall it be? If it is under Mudarabah, then the operator has no right, since the fund belongs to the participants. If it is under Tabarru', it is not necessary to give back to the participants, and the participants cannot expect any surplus to be given to them, as mentioned by Sheikh Yusuf al-Qardawi above.

Since the modified Mudarabah brings so many Shariah-related questions, why not go for the pure Mudarabah or Wakalah models? In answering this question, Mr. Azman agreed that either a pure Mudarabah model or a Wakalah model must be used. However, he pointed out that the modified Mudarabah model had been in use since the advent of Takaful in Malaysia and to implement a change would take time. Furthermore, he added, there are opinions suggesting that deduction of expenses under the Mudarabah principle was not allowed, with the result that the pure Mudarabah model was not viable.

Continued...

Takaful Interview with Azman Wong Ismail *(continued...)*

"That is why the Takaful company concerned uses the modified Mudarabah model," he said, noting that from the operational prespective, a modified Mudarabah model could be considered superior to pure Mudarabah.

Under a pure Mudarabah model, profits to the operator depend only on its ability to generate business and investment return. The more business it generates, the more funds it has. Consequently, the more funds it has, the more profits it will generate from investment. On the other hand, under a modified Mudarabah model, the operator's profits also depend on the quality of business. Therefore profits to the operator depend more on the operator's ability to manage its risk, rather than its ability to generate business and investment. In this respect, the operator is more of a risk manager than an asset management company.

A possible argument to justify the modified Mudarabah model is that the Takaful operator participates in the risk. Therefore it makes the Takaful operator prudent, as it has to ensure quality risks. This is so since under the modified Mudarabah model, profit transferred to the shareholders' funds are from the underwriting surplus. If the Takaful operator is not prudent, the surplus ratio will be small, hence the income transferred to the shareholders' funds will also be of a small amount. On the other hand, under the pure Mudarabah model and the Wakalah model, the Takaful operator need not be prudent, as income to the shareholders' fund is basically a function of an asset management company.

"Since prudence is necessary to operate a Takaful business and since the pure Mudarabah and Wakalah models do not factor these characteristics, we are left with the modified Mudarabah model for general Takaful," he claimed.

Concluding the interview, he said that the modified Mudarabah model had yet to be fully justified as the points mentioned were not argued from the Shariah perspective.

MOVES

IHILAL – UAE (Dubai)

Sheikh Yousef Hasan Khalawi has been appointed Chairman of iHilal Financial Services. Sheikh Yousef worked as a Professor at Al Imam Mohamad Bin Saud University in Riyadh before moving into financial investments and consultancy. Sheikh Yousef holds a Masters Degree in Shariah.

In addition, Nidal Barghouti was appointed Chief Executive Officer. Prior to joining iHilal, Mr Barghouti was the Head of FX and Bullion in the Treasury Department of NCB in Jeddah.

PRUDENTIAL ASSURANCE MALAYSIA – Malaysia

Tan Kar Hor has been appointed as the new Chief Executive Officer for Prudential Assurance Malaysia.

Tan has worked for the company since he joined in 1990 as an assistant manager. He replaces Ng Keng Hooi as CEO. Ng has been promoted to Regional Managing Director of Prudential Corp Asia, where he is responsible for Prudential's life insurance businesses in Malaysia, Singapore, Indonesia and the Philippines.

EMIRATES BANK – UAE (Dubai)

Emirates Bank has appointed Rick Pudner to be CEO, following the resignation of Anis Al Jallaf, who will continue as a Director of the Emirates Bank Board.

Mr Pudner has worked for HSBC for over 24 years in 11 different geographic regions and carries a wealth of general banking expertise.

NATIONAL INVESTOR – UAE (Abu Dhabi)

The National Investor has appointed Amer Halawi to be Head of Research.

Mr Halawi will be responsible for expanding and managing the research team. He has over nine years of experience in European equity markets.

SARAYA JORDAN – UAE (Dubai)

Saraya Jordan has appointed Dr Khalid Al Wazani to the role of General Manager of Saraya Aqaba.

Dr Wazani is an expert in the fields of economy and investment, most recently serving as Deputy Chairman and Director General for the Social Security Corporation in Jordan. Dr Wazani has a Masters degree in Economics from the American University in Cairo, as well as a PHD in Economics from Cairo University.

LINKLATERS – UAE (Dubai)

Linklaters has appointed Luma Saqqaf to be its new Head of Islamic Finance in the Middle East. Ms Saqqaf comes to Linklaters from Allen & Overy, where she focused on transactional banking work with a particular emphasis on Islamic finance. Her experience includes advising on Sukuk, Islamic derivatives transactions and acting on a wide range of Islamic financings.

Senior projects lawyer, Mark Craig, has been made a Managing Associate. Mr Craig was previously a senior associate in the projects group of Clifford Chance and has a broad range of experience in the Middle East. He has just closed the largest ever combined power and water project in the world, the US$2.5 billion Shuaibah IWPP project (see News Brief in the last issue of Islamic Finance *news*).

Both these new appointments will join Linklaters' new Dubai office.

SOLIDARITY – Bahrain

Solidarity has appointed Martin Whelan as Head of Strategic and Business Planning of the Family Takaful Division.

Mr Whelan has over 20 years of international experience in the insurance sector, and has previously held senior management roles in Zurich International Life, Saudi American Bank, Eagle Star International Life, Prudential Insurance and the Chelston Partnership.

THE NATIONAL INVESTOR – UAE (Abu Dhabi)

The National Investor has appointed Amer Halawi as Head of Research. Mr Halawi has over nine years' experience in European equity markets, previously working at Goldman Sachs.

In his new role he will be responsible for expanding and managing the research team, and delivering value-added investment advice on regionally listed companies.

Bondweb MALAYSIA

MALAYSIA ISLAMIC BOND UPDATE

Bondweb MALAYSIA

RINGGIT ISLAMIC DEBT MARKET: FORTNIGHTLY SNAPSHOT

AS AT 8th Feb 2006

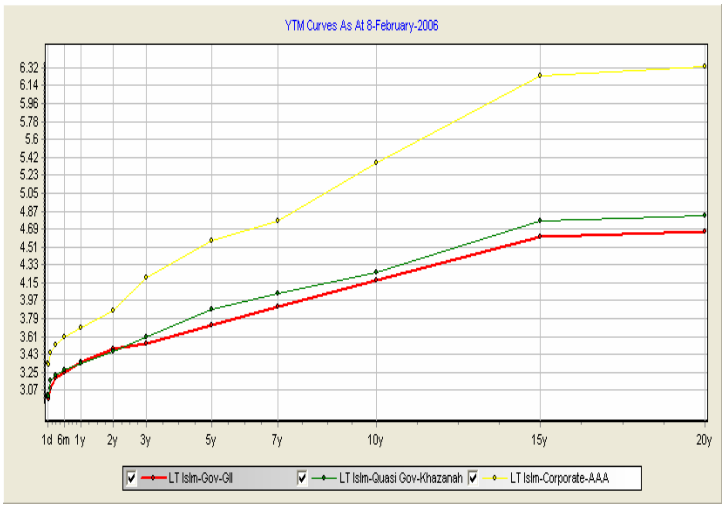
Key Benchmarks Trend (by volume)	Rating	This week close (RM)	1/02/2006 (RM)	25/01/2006 (RM)	18/01/2006 (RM)
Private Debt Securities					
OPT CHEMIC 4.28000% 29.09.2008	AAA ID (MARC)	100.91	100.94	101.16	101.23
EVERMASTER 0.00000% 30.12.2010	A- ID (MARC)	100.78	100.00	101.41	101.40
PLUS PRIMARY BONDS SERIES 5 – 31.05.2007	AAA (RAM)	102.08	102.18	102.25	102.34
ENCORP 0.000% 03.01.2008	A1 (S) (RAM)	91.04	90.90	91.25	91.24
PLUS PRIMARY BONDS SERIES 6 – 30.05.2008	AAA (RAM)	103.93	103.89	104.07	103.99
Government Investment Instruments					
PROFIT-BASED GII 24/2005 08.12.2010	n/a	100.05	100.22	100.26	100.28
GII 1/2003 0.00000% 31.03.2008	n/a	92.90	93.09	93.05	93.08
Quasi Government					
KHA1/00 1.02B 0-CP 7YR 20/3/2007	n/a	96.43	96.36	96.30	96.30
CAGABAIS 10/2005 0% 10.10.2007	AAA (RAM)	99.46	99.47	99.47	99.54
KHA4/99 1B 0-CP 7YR 18/12/2006	n/a	97.24	97.18	97.13	97.13
KHA1/01 700M 0-CP 5YR 20/3/2006	n/a	99.67	99.61	99.55	99.50

SPREAD VS GII (in b.p)

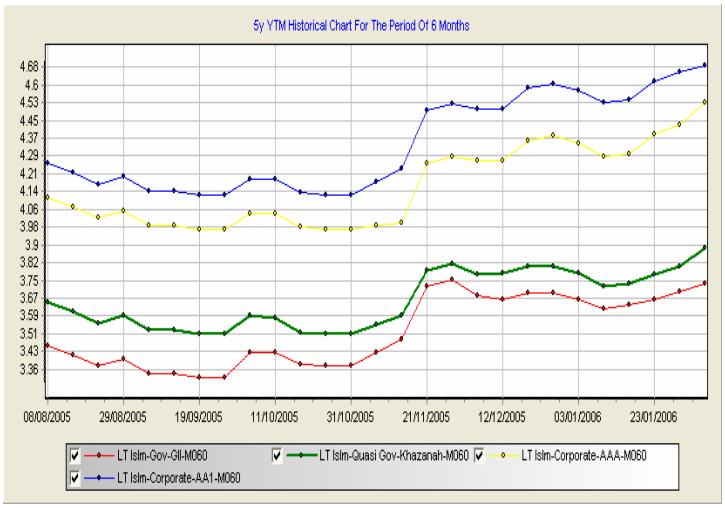
	TENURE					
	1-Year	2-Year	3-Year	5-Year	7-Year	10-Year
GII	3.35	3.48	3.54	3.73	3.91	4.18
Cagamas	0.21	0.28	0.39	0.36	0.37	0.28
Khazanah	-0.01	-0.02	0.07	0.16	0.13	0.08
AAA	0.35	0.39	0.66	0.85	0.86	1.18
AA1	0.37	0.56	0.9	1.06	1.07	1.34
A1	1.1	1.32	1.63	2.41	2.82	2.97

MYR ISLAMIC DEBT YIELD CURVES

YTM Curves



5-YEAR YTM Historical Charts (weekly closing, over last 6 months)



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For enquiries regarding the above information, please contact:
Tel: +603 2711 5125/5126 Fax: +603 2284 1807
Email: enquiries@bondweb.com.my

ISLAMIC LEAGUE TABLES

TOP 20 ISSUERS OF ISLAMIC DEBT — Feb 2005 – Feb 2006

	Issuer or Group	Nationality	Instrument	Amt US$ m	Iss.	%	Manager
1	PCFC Development	UAE	Convertible Sukuk	3,500	2	35.5	Barclays Capital, Dubai Islamic
2	Wings FZCO	UAE	Islamic Sukuk Al Musharakah Issue	550	1	5.6	Dubai Islamic, Standard Chartered, HSBC
3	Cagamas MBS	Malaysia	Sukuk Musharakah Islamic Bond	542	6	5.5	CIMB, HSBC, ABN AMRO, AmMerchant
4	Islamic Development Bank	Saudi Arabia	Islamic Bond	500	1	5.1	Deutsche, HSBC
5	PLUS Expressways	Malaysia	Serial Bai Bithaman Ajil Islamic Securities	349	4	3.5	CIMB
6	Syarikat Bekalan Air Selangor	Malaysia	Bai Bithaman Ajil Commercial Papers/MTNs	273	4	2.8	CIMB, Bank Islam Malaysia, HSBC Bank (Malaysia)
7	Maybank	Malaysia	Islamic Subordinated Bond	265	1	2.7	Aseambankers
8	Senai Desaru Expressway	Malaysia	Bai Bithaman Ajil Islamic Debt Securities	249	26	2.5	Aseambankers, Standard Chartered
9	Jimah Energy Ventures	Malaysia	Istisnah Islamic MTN Facility	245	10	2.5	AmMerchant, RHB Sakura, Malaysian International Merchant Bankers, Bank Muamalat Malaysia
10	Cagamas	Malaysia	Bithaman Ajil Islamic Securities	238	5	2.4	Cagamas/AmMerchant
11	Putrajaya Holdings	Malaysia	Murabahah MTN	235	4	2.4	Alliance Merchant , CIMB, RHB Sakura
12	DRB-HICOM	Malaysia	Bai Bithaman Ajil Islamic Debt Securities	209	11	2.1	AmMerchant, Malaysian International Merchant Bankers
13	Konsortium Lebuhraya Utara-Timur (KL)	Malaysia	Redeemable Secured Serial Sukuk Istisnah	207	9	2.1	CIMB
14	Gold Sukuk dmcc	UAE	Islamic Sukuk Al Musharakah Issue	200	1	2.0	Standard Bank, Dubai Islamic
15	International Bank for Reconstruction & Development – World Bank	Supranational	Bai Bithaman Ajil Islamic Debt Securities	200	1	2.0	ABN Amro, CIMB
16	Musyarakah One Capital	Malaysia	Asset-Backed Sukuk Musharakah Issuance Programme	176	7	1.8	CIMB
17	Special Power Vehicle	Malaysia	Bai Inah Islamic MTN Facility	163	13	1.7	Malaysian International Merchant Bankers, AmMerchant, RHB Sakura, Bank Muamalat Malaysia
18	Ranhill Power	Malaysia	Islamic MTN Programme	142	12	1.4	Aseambankers
19	Sistem Penyuraian Trafik KL Barat	Malaysia	Al Bai Bithaman Ajil Notes Issuance Facility	136	5	1.4	United Overseas Bank (Malaysia)
20	WAPDA First Sukuk	Pakistan	Sukuk Al Ijarah	134	1	1.4	Citibank (Pakistan), Jahangir Siddiqui & Co, MCB Bank
	Total of issues used in the table			9,861	283	100.0	

For all enquires regarding the above information, please contact: Catherine Chu
Email: Catherine.Chu@Hk.Dealogic.com
Phone: +852 2804 1223; Fax: +852 2529 4377

ISLAMIC LEAGUE TABLES

TOP 20 ISSUERS OF ISLAMIC DEBT — Aug 2005 – Feb 2006

	Issuer or Group	Nationality	Instrument	Amt US$ m	Iss.	%	Manager
1	PCFC Development	UAE	Convertible Sukuk	3,500	2	56.9	Barclays Capital, Dubai Islamic
2	Syarikat Bekalan Air Selangor	Malaysia	Bai Bithaman Ajil Commercial Papers/MTN	273	4	4.4	CIMB, Bank Islam Malaysia, HSBC Bank (Malaysia)
3	Maybank	Malaysia	Islamic Subordinated Bond	265	1	4.3	Aseambankers
4	Senai Desaru Expressway	Malaysia	Bai Bithaman Ajil Islamic Debt Securities	249	26	4.0	Aseambankers, Standard Chartered
5	Putrajaya Holdings	Malaysia	Murabahah MTN	235	4	3.8	Alliance Merchant Bank, CIMB, RHB Sakura
6	Konsortium Lebuhraya Utara-Timur (KL)	Malaysia	Redeemable Secured Serial Sukuk Istisnah	207	9	3.4	CIMB
7	Sistem Penyuraian Trafik KL Barat	Malaysia	Al Bai Bithaman Ajil Notes Issuance Facility	136	5	2.2	United Overseas Bank (Malaysia)
8	WAPDA First Sukuk	Pakistan	Sukuk Al Ijarah	134	1	2.2	Citibank (Pakistan), Jahangir Siddiqui & Co, MCB Bank
9	Antara Steel Mill	Malaysia	Al Bai Bithaman Ajil Islamic Debt Securities	133	6	2.2	AmMerchant
10	Sime Darby	Malaysia	Al Murabahah CP/MTN Programme	133	1	2.2	CIMB, HSBC Bank (Malaysia)
11	Cagamas	Malaysia	Bithaman Ajil Islamic Securities	132	1	2.2	AmMerchant
12	Golden Crop Returns	Malaysia	Sukuk Al Ijarah	117	15	1.9	Affin
13	Bayu Padu	Malaysia	Istisnah Serial Bonds	66	8	1.1	United Overseas Bank (Malaysia)
14	Tenaga Nasional	Malaysia	Murabahah MTN Programme	66	1	1.1	United Overseas Bank (Malaysia), Aseambankers Malaysia, Bank Muamalat, KAF Discount, AmMerchant Bank, CIMB
15	Sarawak Gateway	Malaysia	Redeemable Secured Serial Sukuk Ijarah	64	6	1.0	CIMB, RHB Sakura
16	Harum Intisari	Malaysia	Murabahah Commercial Paper/MTN Programme	53	1	0.9	HSBC Bank Malaysia
17	Sweetwater SPV	Malaysia	Serial Bai Bithaman Ajil Islamic Securities	52	3.0	0.8	Avenue Securities
18	Focal Quality	Malaysia	Sukuk Al Ijarah	50	8.0	0.8	OCBC Bank (Malaysia)
19	Sacofa	Malaysia	Istisnah Islamic Bond	42	6.0	0.7	CIMB, RHB Sakura
20	ASSAR Chemical	Malaysia	Sukuk Musharakah	40	8.0	0.6	RHB Sakura
	Total of issues used in the table			6,150	151	100.0	

ISLAMIC LEAGUE TABLES

ISLAMIC DEBT — FEB 2005 – FEB 2006

	Manager or Group	Amt US$ m	Iss.	%Share
1	Dubai Islamic	2,033	4	20.6
2	Barclays Capital	1,750	2	17.7
3	CIMB	1,412	52	14.3
4	HSBC	924	17	9.4
5	AmMerchant	543	52	5.5
6	Aseambankers	542	40	5.5
7	Standard Chartered	316	28	3.2
8	RHB	280	49	2.8
9	Deutsche	275	3	2.8
10	United Overseas	264	23	2.7
11	EON Bank	206	34	2.1
12	Bank Muamalat Malaysia	179	49	1.8
13	Affin Merchant	136	17	1.4
14	Alliance Merchant	132	14	1.3
14	OCBC	111	26	1.1
16	Cagamas	105	4	1.1
17	ABN AMRO	100	1	1.0
18	Standard Bank Group	100	1	1.0
19	Bank Islam Malaysia	91	4	0.9
20	Avenue Securities	52	3	0.5
	Total of issues used in the table	**9,861**	**283**	**100.0**

ISLAMIC DEBT — AUG 2005 – FEB 2006

	Manager or Group	Amt US$ m	Iss.	%Share
1	Barclays Capital	1,750	2	28.5
2	Dubai Islamic	1,750	2	28.5
3	CIMB	516	34	8.4
4	Aseambankers Malaysia	400	28	6.5
5	AmMerchant	316	12	5.1
6	HSBC	220	9	3.6
7	United Overseas Bank	214	14	3.5
8	RHB	178	26	2.9
9	Affin Merchant	136	17	2.2
10	Standard Chartered	125	26	2.0
11	Bank Islam Malaysia	91	4	1.5
12	OCBC	86	18	1.4
13	Alliance Merchant	81	5	1.3
14	Avenue Securities	52	3	0.8
14	Citigroup	45	1	0.7
16	Jahangir Siddiqui & Co	45	1	0.7
17	MCB Bank	45	1	0.7
18	KAF Discount	40	7	0.7
19	Deutsche	25	2	0.4
20	OSK Asia Securities	13	4	0.2
	Total of issues used in the table	**6,150**	**151**	**100.0**

ISLAMIC DEBT BY COUNTRY — FEB 2005 – FEB 2006

	Amt US$ m	Iss.	%Share
Malaysia	4,716	273	47.8
UAE	4,250	4	43.1
Saudi Arabia	500	1	5.1
United States	200	1	2.0
Pakistan	134	1	1.4
Indonesia	61	3	0.6
Total	**9,861**	**283**	**100.0**

ISLAMIC DEBT BY COUNTRY — AUG 2005 – FEB 2006

	Amt US$ m	Iss.	%Share
UAE	3,500	2	56.9
Malaysia	2,516	148	40.9
Pakistan	134	1	2.2
Total	**6,150**	**151**	**100.0**

ISLAMIC DEBT BY CURRENCY — FEB 2005 – FEB 2006

	Amt US$ m	Iss.	%Share
Malaysian ringgit	4,916	274	49.9
US dollar	4,750	5	48.2
Pakistan rupee	134	1	1.4
Indonesian rupiah	61	3	0.6
Total	**9,861**	**283**	**100.0**

ISLAMIC DEBT BY CURRENCY — AUG 2005 – FEB 2006

	Amt US$ m	Iss.	%Share
US dollar	3,500	2	56.9
Malaysian ringgit	2,516	148	40.9
Pakistan rupee	134	1	2.2
Total	**6,150**	**151**	**100.0**

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For more information, please contact
Andrew Tebbutt on
+603 2141 6022 or
Andrew.Tebbutt@RedMoneyGroup.com