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CIAWM also welcomes Professor Zulkarnain Mohd Sori as the new Deputy Director of the Centre, effective October 2017, replacing Dr Eskandar Shah Mohd Rasid, who is now the Dean of the School of Graduate Studies.

In 2017, with the Grace of the Almighty, the Centre reached a significant milestone in completing a book on Islamic Wealth Management: Theory and Practice. It has 21 chapters covering most aspects of Islamic Asset and Wealth Management. Chapter contributions came from both the academia and the industry experts. It is published by Edward Elgar (EE) Publishers (UK), and currently in print and expected to be in the market by January 2018.

In support of the BNM’s initiative to further improve our globally acknowledged Islamic banking industry, research was initiated on “Perception of Islamic bankers and their Institutional clients on Islamic banking services”. A survey was done on seventeen Islamic financial institutions in the country. The paper on the findings is completed and a booklet is being prepared for the regulators and the industry.

Three BNP Paribas Scholars (Dr Mohd Moutaz Abojeib, Dr Mazhar Kantakji and Dr Mahmoud Alhomsli) graduated in 2017. Their research output has been presented at international conferences and their papers submitted to reputable international mainstream finance journals.

In 2017, the Centre continued the focus on the theme of Global Fund Administration, in support of the government’s initiative gazetted in the Islamic Finance Master plan, prepared by the Securities Commission (SC). An opinion survey will be conducted, of fund administrators and regulators to get their view of what it would take for Malaysia to become a global hub for Islamic fund administration. Consultation and discussions were held with the industry (local and foreign fund managers and administrators) and the regulators. The final report on possible strategies to achieve this objective will be documented in a booklet as a guide or blue-print for the Fund Management Industry including regulators. This will followed by a conference on the same theme in March 2018.

I take this opportunity to thank INCEIF and BNP Paribas for their support. This message will not be complete without a special mention of appreciation for the Chairman of the Advisory Board of the Centre, Professor Datuk Dr Syed Othman Alhabshi and the former Deputy Director, Dr Eskandar Abdul Rasid for their dedication and undivided commitment in successfully facilitating all the activities initiated by the Centre. Professor Datuk Dr Syed Othman Alhabshi has retired since July 2017 and Dr Eskandar is now the Dean of the School of Graduate Studies. My special thanks to Associate Professor Dr Baharom Abdul Hamid (the Director of the Research Management Center at INCEIF), Dr Ziyaad Mahomed and Dr Wajahat Azmi, for their committed support in facilitating the activities of the Centre. I look forward to their continuous support.
Welcome to the 3rd volume of the Centre’s bulletin on Islamic Wealth Management. This edition marks a milestone as the largest to date, with 9 articles covering pertinent industry and academic-related issues. Contributions have been provided primarily from CIAWM scholars, showcasing the depth and impact of their research over the period.

We begin with an empirical analysis on comparatively assessing managerial skills of Shariah-compliant and socially responsible funds through a test of macroeconomic efficiency and fund flows. The findings are relevant as they suggest that there is no apparent return sacrifice for ethical investment, supporting the view that ‘doing good’ may be profitable as well.

Since global focus has shifted towards the achievement of the UNSDG 17 (United Nations Sustainable Development Goals), we have included relevant research that discusses the issue. For example, Gadhoum investigates whether Islamic banks have a correlation between financial performance and ethical disclosure. The findings provide further insight into the financial impact of ethical ideals at Islamic banks, considering that the fundamentals of the industry are based on values entrenched in the Shariah.

A feature article on the subject of UNSDG discusses the revival of Islamic Social Finance (ISF) through selected instruments designed for social welfare and development: zakat, waqf and sadaqah. The article submits that these instruments will be used as tools of socio-economic development and new initiatives in the banking industry, led by VBI or value-based intermediation.

We also provide a brief article based on the research conducted by the Centre on establishing Malaysia as a global hub for fund administration. The full research report is expected to be released within the 1st quarter of 2018, analyzing the leading fund administration centers and identifying existing gaps in the Malaysian offering, that have the potential for enhancement, particularly in the field of Islamic fund administration.

Finally, we present an article on the essentials of cryptocurrency and the global Shariah verdicts to date. The phenomenal rise of Bitcoin and other leading cryptocurrencies has prompted significant debate on the Shariah legitimacy of purchasing, trading and mining digital currency. The Shariah opinions are mixed and evolving as more information is made available about the nature and functions of this digital currency.

Besides these, there are other articles that provide valuable insight on topics related to Islamic wealth management. We trust that this publication will be useful and beneficial in sharing knowledge on relevant issues of Islamic wealth management with the readers.

“This edition marks a milestone as the largest to date, with 9 articles covering pertinent industry and academic-related issues.”
Market Timing and Selection Skills of Fund Managers: Are Managerial Skills of Shariah-Compliant and Socially Responsible funds any Different?

By Dr Wajahat Azmi
Prof Dr Shamsher Mohamad
Assoc Prof Dr Mohamed Eskandar Shah

We assess the managerial skills of globally invested 686 ethical funds taking into consideration the macroeconomic efficiency and fund inflows/outflows. It was observed that managers exhibit negative selection and market timing skills but no consistent pattern for style timing.

A cursory glance at the literature indicates little support for superior managerial abilities, especially in terms of timing skills. Notwithstanding, some have highlighted the importance of including fund flows in the traditional models and argue that excluding it can lead to spurious timing skills (Bollen and Busse, 2001). The findings indicate that the investors increase their exposure to funds during a bullish period and reduce it during a bearish period. The increase in cash holdings of fund companies during a bullish period leads to lower beta whereas a temporary decrease in cash position leads to higher fund beta. Both the scenarios lead to underestimation of timing abilities and suggest that the test of skills without taking into account the fund flows may undermine the true skills of the managers.

In recent times, the emergence and increasing popularity of socially responsible funds (SRFs) and Shariah-compliant funds (SCFs) has led to a significant niche class of asset in its own right and hence, the importance to examine them as a separate asset class¹. More importantly, the increasing popularity of ethical funds have even prompted the conventional funds to offer tailored financial products to meet investors demand. Given its increasing growth and acceptance at the global level, it is important to investigate some relevant issues surrounding these funds.

We examine the relationship between managerial skills and the fund flow of these niche funds. Documenting the managerial skills of SCF and the SRF managers is important for at least two reasons. First, both types of funds are subjected to a screening process that reduces

¹ As per Global Sustainable Investment Review (GSIR) 2016, at the start of 2016, total of $22.89 trillion of assets were professionally managed based on SR principles. On the other hand, as at end Q1 2017, total Islamic funds under management reached $70.9 billion (Islamic funds: Gearing Up, MIFC – 2017).
the scope of the investment universe to select assets that could affect the portfolio’s diversification strategy. The issue becomes more pertinent with the increase in money flow into the funds that could lead to decisions to invest in stocks with lower risk-adjusted return, implying an adverse impact on the stock selection skills of managers. Second, the constituent stocks are screened periodically to ensure continuous compliance with the set guidelines. The continuous readjustment of portfolios due to non-compliance will affect the market timing skills of the managers. It is therefore important to control for the fund flow effects when measuring managerial selection and timing skills.

A survivorship-free bias sample of 686 equity-based open-ended funds with 212 SCFs and 474 SRFs with an investment focus in Asia Pacific, Emerging markets, Europe, Global (with no focus to any specific country or region), Middle East and North Africa (MENA) and North America was selected for analysis. The data was sourced from Eurekahedge, Bloomberg and fund prospectuses for both the funds, for the period January 2002 to December 2013. Before we did so, we also examined the performance of these funds. To achieve the objective, we utilized the single (CAPM) as well as the three-factor Fama-French model and four-factor CARHART model (1997). As the four factors are not available for all the regions, we construct the factors based on the Worldscope database. To examine the skills, we apply two of the most widely used measures proposed by Treynor and Mazuy (TM) (1966) and Merton and Henriksson (HM) (1981). An extended version of TM and HM models was applied to examine style-timing abilities and to demarcate the skills with the money flowing into/out of these funds and pure skills induced by the fund flows.

Our findings show that both types of funds significantly underperformed the market, consistent with Capelle-Blancard and Monjon (2014) and Nainggolan’s et al. (2016) findings. The stock selection and market timing skills are negative, consistent with Ferruz et al. (2012) and Mohammad and Ashraf (2015), but inconsistent with that of Hammami and Oueslati (2017). The findings are inconclusive on the style timing capabilities of these funds as no consistent pattern is observed across different models. It is possible that the poor selection and timing skills of these managers are due to a smaller investment universe where the ability to diversify is limited and the results may be biased as fund flows are omitted.

An extended analysis that incorporates fund flows also revealed no significant effect on the skills, as the timing coefficient remained negative and significant. These findings are consistent with Munoz et al. (2014) that also documented no effect of fund flows on managerial skills. To control for macroeconomic efficiency, re-estimations were made by incorporating important macro factors into the models, but no significant changes were observed.

Several policy implications could be inferred from the findings. First, it could be that SCF/SRF managers are still in the learning phase and require a longer learning curve to improve their selection and timing skills. The increasing validation that the return of SCF/SRF indices is comparable to their conventional counterparts exerts added pressure on these fund managers to be competitive for long-term survival.

The findings on the performance of SCF/SRF indices suggest that, at worst, the performance of these indices are at par with the conventional benchmark, which imply that the SCF/SRF investors would be better off by investing in the SCF/SRF indices. It also implies that to motivate the SCF and SRF fund managers, the remuneration of these managers needs to be benchmarked based on performance and must be as competitive, if not better, than their conventional counterparts. This is in the interest of mitigating any moral hazard issues and providing an incentive for them to be more committed. In fund management parlance, managers should have more skin in the game.
The Corporate Ethical Identity Disclosure and Its Impact on Financial Performance: Evidence From Islamic Banks Globally
The importance of ethics in the corporate world has received much attention in the 21st century, after a series of major financial fiascos. In fact, most of the performance of companies in the market have a new dimension of qualitative analysis besides the usual financial analysis that generate quantitative information to ascertain their performance (Guthrie and Farnetti, 2008). Dhalwal et al. (2011) point out that greater disclosure and transparency aligned with non-financial disclosures (social, ethical and environmental) play a complimentary role to financial transparency, leading to lower analyst forecast errors. Therefore, a more objective assessment of expected financial performance is achieved.

Proponents of ethical reporting argue that organizational transparency through such reporting is the strategy for achieving a better corporate accountability and the key to meaningful stakeholder engagement. In response to stakeholders’ concerns about corporate ethics, many firms are increasing their level of ethical, social and environmental disclosure through different means on a periodical basis.

Following this rationality, Islamic financial institutions (IFIs) are expected to embed ethics and social responsibility in their business model by default (Baydoun and Willett, 2000; Lewis, 2001). Furthermore, the shariah governance of IFIs ensures their conformity with the Islamic fundamentals, with the expectation that it would translate into more transparent and adequate disclosure. However, preliminary evidence does not support this notion, as IFIs fail to maintain their unique identity (ideal) and their current state seems to be controversial (Haniffa and Hudaib, 2007).

Despite all the initiatives to improve governance after every crisis event, corporate ethical identity (CEI) reporting has not gained much attention, compared to corporate social reporting in the Islamic finance industry. The documented evidence on CEI disclosure is limited and focuses on either the determinants (e.g., Farook et al., 2011) or on a micro level of such a reporting (e.g., Maali et al., 2006; Haniffa and Hudaib, 2007; Hassan and Harahap, 2010; Aribi and Gao, 2012). In addition, most previous studies explored the ethical or socially responsible identity disclosure before the issuance of AAOIFI governance standard No.7 (2010). The standard provides a template for IBs to adopt ethical and social reporting. Though the AAOIFI standards are not legally binding for the IBs to follow, it will be interesting to note the effectiveness of these standards in promoting ethical behavior among the IBs.

In addition, there is an empirical question of whether ethical identity in Islamic banks has value or improves financial performance. This article summarize the findings on this issue and provides information on whether investors value ethics in their investment decisions.

Based on the Banker’s and World Bank’s databases, data was collected for 56 banks in South-East Asia, South Asia and Middle East and North Africa (MENA) regions, for the period 2010-2015. Then, the ethical identity index (EI1) was applied to classify the sampled banks based on 4 themes, 7 dimensions and 44 constructs.
The findings indicate no association between ethical identity disclosures and Islamic banks’ financial performance (Maali et al., 2006). Also, the low level of disclosure might be because IBs operate in an environment where governance is not strictly enforced and not much attention is given by its stakeholders on the issue of disclosure. The little impact of ethical and social ideals and the huge gap between theory and practice provides evidence of the capitalistic nature of the Islamic banking system in general (Khan, 2006). In other words, the attempts to emphasise the religious and spiritual dimensions of the bank through disclosing their vision and mission and their commitment to shariah rulings are flawed, from the perspective of achieving the proclaimed goals and roles they aspire to. The implication of the poor disclosure practices will be high reputational risks and the likelihood of loss of customers and investor confidence, which will certainly affect the long-term growth of the IB industry.

In addition, the results reveal that following AAOIFI standards or otherwise, have no impact on the ethical disclosure practices of Islamic banks.

The findings suggest that firms do voluntarily disclose information in their annual reports as a strategy to manage their legitimacy. This is in support of the legitimacy theory, indicating a highly significant positive association between the age of IB and ethical identity disclosure. This suggests that older companies with longer societal existence may have taken relatively more legitimacy and may have a higher reputation and involvement of social responsibility than younger companies. This relationship exists because long-established companies have received more benefits from society than newly established firms. Furthermore, the more mature firm undertakes a greater leadership role, developing an increased sense of ethical and social responsibility (Hossain and Hammami, 2009; and Hanif and Cooke, 2002).

Finally, the findings indicate no association between ethical identity disclosures and Islamic banks’ financial performance. The difficulty to find a direct link between the corporate ethical identity disclosure and financial performance may be due to the lack of proper measurement (McWilliam and Siegel, 2001) and limits concerning concepts, methodologies and data used (Allouche and Laroche, 2006).
Risky Bonds and Futures Asset Pricing

By:

Prof Dr Belal Ehsan Baaquie
Mr Yu Miao
The global bond market is the main component of the capital market, being about three times larger than the global equity markets. In 2009, the global bond market (total outstanding debt) was estimated to be $82.2 trillion; the US dominated the bond market with the outstanding U.S. bond debt at approximately $35.2 trillion\(^1\). Risk-free forward interest rates — and their realization by US Treasury bonds as the leading exemplar — have been studied extensively. The bond market considers US Treasury bonds as being risk-free instruments and consequently have the lowest yields. In [1], models of risk-free bonds and their forward interest rates based on the quantum field theoretic formulation of the risk-free forward interest rates have been discussed, including the empirical evidence supporting these models. The quantum finance formulation of risk-free forward interest rates is extended to the case of risky forward interest rates. The example of the Singapore and Malaysian forward interest rates are used as a specific case of risky bonds. The main feature of the quantum finance model is that the risky forward interest rates are modelled both as a stand-alone case as well as being driven by the US forward interest rates, plus a spread — having its own term structure — above the US forward interest rates. Sovereign bonds of the developed as well as emerging countries are considered to be risky bonds and are benchmarked against the US risk-free interest rates; the spread above the US rates is determined by the country-specific risk.

A mathematical model has been developed in [6], with the spread of risky interest rates above the risk-free rates being modelled with a complete term structure. The formalism of quantum finance has been employed for the modelling. An empirical calibration of the model has been carried out for the US Treasury bonds as well as the Singapore and Malaysian sovereign bonds. Both the US forward interest rates and the term structure for the risky bond spread are modelled by a two-dimensional Euclidean quantum field.

The calibration and testing of the proposed model for the Singapore sovereign bond shows good results. As a precursor to the evaluation of a put option of the Singapore coupon bond, the quantum finance model for swaptions is tested using an empirical study of US Dollar swaptions; market data shows that the model is quite accurate. A prediction for the market price of the put option for the Singapore coupon bond is obtained using the quantum finance formulation of the Singapore forward interest rates. The quantum finance model is generalized to study the Malaysian case and the model’s prediction for a Malaysian interest rate swap is obtained.

The Malaysian forward interest rates are shown to have anomalies absent for the US and Singapore case. The statistical theory of asset prices has been formulated by [2]. Further empirical studies of single [3] and multiple commodity prices [4] have provided strong evidence in support of the primary assumptions of the statistical formulation. A model has been proposed by [5] that extends the model for spot prices [2] to model futures commodity asset prices using a statistical field theory of futures prices. The futures prices are modelled as a two-dimensional statistical field and a nonlinear Lagrangian is postulated. Empirical studies provide clear evidence in support of the model, with many nontrivial features of the model finding unexpected support from market data.

References

\(^1\) https://en.wikipedia.org/wiki/Bond_market
Does Diversification Improve Bank Performance in Dual-Banking Systems?

By:

Mirzet SeHo
Conventional intermediation theories argue that imperfections in financial markets are a raison d’être for financial intermediaries such as banks. Islamic banks are no different from their conventional counterparts in this regard as they too perform similar intermediary functions. However, unlike their conventional counterparts, the principles of Islamic banks are different as they are operated on Shariah-based precepts of riba avoidance and risk sharing. In practice, however, Islamic banks are claimed to be likened to conventional banks, which raises concerns about possible convergence of these two banking systems over time.

Regardless of these claims, Islamic banks are distinguishable from their conventional counterparts in at least two regards: first, a significant portion of Islamic banks’ deposits is in investment accounts (44.11% as of 2014 according to IFSB), which are equity-like in nature and second, their financings are linked to a real asset or real economic activity. In conventional banking, all deposit and lending activities are debt-based. Consequently, it is expected that the risk-return profiles of the two banking systems differ considerably, though both pursue the objective of maximizing profits per unit of risk or minimizing risk per unit of profit. The modern portfolio theory postulates that the latter can be achieved through optimal diversification strategies. However, corporate finance theorists suggest that diversification strategies increase complexity, overhead costs, agency costs and inefficiency and that the objective of minimizing risk per unit of profit is best achieved by focussing on their business lines so as to take advantage of management’s expertise.

The literature is inconclusive on these opposing arguments. The diversification literature is mainly on conventional banking and there is scarce evidence on Islamic banking.

Given the scant literature, a study was carried out to evaluate the impact of sectoral and contractual diversification on bank returns and risk in dual-banking systems. The former is based on the economic sectors to which financing and loans are extended and the latter is based on the underlying contracts used for such financing and loans. While the former is applicable to both Islamic and conventional banks, the latter is applicable only to Islamic banks. Using the Herfindahl-Hirschman Index and Shannon Entropy measures, the research attempted to answer the following questions: (i) does the loan and financing portfolio diversification across different economic sectors have any impact on returns and risk of banks in dual-banking systems; Is the impact the same for Islamic and conventional banks? (ii) does the diversity of Shariah contracts have any impact on returns and risk of Islamic banks? (iii) does the impact of diversification on bank returns in dual-banking systems vary with the risk level; and, is the impact the same on both Islamic and conventional banks? (Note: while sectoral diversification applies to both bank types, contractual diversification applies to Islamic banks only).

An analysis of 106 banks (46 Islamic and 60 conventional) from six-dual-banking system countries, namely, Malaysia, Bahrain, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates for the period 2005-2015, shows the following preliminary findings:

1. Conventional banks are on average better diversified in terms of sectoral diversification than Islamic banks. This, however, is expected given that Islamic banks are restricted from engaging in financing illicit activities/sectors by Shariah. 2. Prior to the 2008 global financial crisis, both types of banks experienced negative trends in sectoral diversification, but the trends reversed in post-crisis though have not reached the pre-crisis level. 3. Contractual diversification, on the other hand, is comparatively much lower than sectoral diversification and has been declining for the most part of the period for Islamic banks. 4. Conventional banks are relatively larger in size, more profitable, less volatile, and have better quality loans, whereas Islamic banks are better capitalized and more engaged in financing (lending) business.

However, a detailed analysis summarized in the Table below suggests the following conclusions:

### Table: Sectoral and Contractual Diversification Efforts

<table>
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<th>Conventional Banks</th>
<th>Islamic Banks</th>
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<td>ROAA</td>
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<td><strong>Sectoral Diversification by HHI</strong></td>
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<td>Overall</td>
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<td>▼</td>
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<td>@ different risk levels</td>
<td>▼ if NPL≤7</td>
<td>▼ if NPL≤19</td>
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<td><strong>Sectoral Diversification by SE</strong></td>
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<td>Overall</td>
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<tr>
<td>@ different risk levels</td>
<td>▼ if NPL≤8</td>
<td>▼ if NPL≤7</td>
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<td><strong>Contractual Diversification by HHI</strong></td>
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<tr>
<td>Overall</td>
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<tr>
<td>@ different risk levels</td>
<td>△ if NPL≥14</td>
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<td><strong>Contractual Diversification by SE</strong></td>
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<td>Overall</td>
<td>△</td>
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<tr>
<td>@ different risk levels</td>
<td>△ if NPL≥20</td>
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Note: △ Means an Increase  ▼ Means a decrease  ❌ Means insignificance
“Islamic banks rely heavily on debt-based contracts”

Table: Summary of Regression Results

| Sectoral diversification has a negative impact on returns and a positive impact on risk of banks in dual-banking systems. This impact is evidenced in both Islamic and conventional banks and there is no difference in how sectoral diversification affects Islamic and conventional banks. |

The impact of sectoral diversification on bank returns varies across risk levels. It negatively affects returns at low-risk levels and has no effect at moderate- and high-risk levels. Overall, both Islamic and conventional banks are subject to the same effects of sectoral diversification with marginal differences in the effect magnitude.

The effects of sectoral diversification vary to some degree across our six countries. It has a negative impact on Malaysian bank returns at all levels; it has a negative impact on Bahraini, Kuwaiti and UAE bank returns at low-risk levels, but a positive impact at high-risk levels; and, it has no impact on Saudi and Qatari bank returns at all.

The 2008 crisis played a crucial role in determining the course of sectoral diversification effect on bank returns. Prior to the crisis, it had no effect at all. The effect turned negative only in the post-crisis.

By and large, contractual diversification is found to have no effect on either returns or risk of Islamic banks. There is weak evidence of negative effects at high-risk levels and positive effects at very-low-risk levels.

In brief, there are diseconomies of sectoral diversification for banks, both Islamic and conventional, that expand into new sectors. These diseconomies arise in the form of reduced returns concurrently with worsening of credit quality (increased risk). By implication, banks in dual-banking systems can increase their returns and lower their risk if they focus or concentrate on one sector or a smaller group of sectors. In addition, relatively high levels of diversification amongst banks did not provide any buffer against the 2008 crisis. In fact, it made things worse. As for the contractual diversification, for the most part, it does not come with either economies or diseconomies. There is only some weak evidence that there are marginal economies for Islamic banks at very-low-risk levels and diseconomies at high-risk levels.

There are at least four possible reasons for diseconomies of sectoral diversification. First, the bank management might lack the necessary expertise for good quality screening, selection and monitoring of borrowers in new sectors. This affects their monitoring effectiveness and makes the exposure to new sectors costlier. This is usually reflected in the increased provision for bad and non-performing loans and financing, and consequently reduction in returns. Second, due to competitive conditions in the new sectors, banks may be subject to adverse selection and a winner’s curse effect. Third, due to a lack of effective market discipline and monitoring by shareholders, managers may not pursue the diversification or focus strategy that maximizes shareholder value. The high concentration of banks provides additional comfort to the managers to pursue their own agendas by increasing their market power at the expense of efficiency.

As for the contractual diversification, Islamic banks heavily rely on debt-based contracts. This supports the notion of convergence in practice.

The findings lend support to the suggestions by corporate finance theorists that banks should focus on their business lines to take advantage of management’s expertise and minimize agency problems. For both banking systems, diversification does not seem to support their objective of minimizing risk per unit of returns.

From the policy perspective, regulators should design policies that limit the sectoral diversification levels and incentivize de-diversification of the banking sector. Since poor management and lack of expertise may be the cause of diversification diseconomies, there must be some comprehensive supervisory standards for effective internal monitoring and evaluation and risk management. The heavy reliance on debt-based contracts in Islamic banks requires some support from regulators to help Islamic banks foster their axiomatic competencies by creating at least a level playing field if not a favourable environment for equity-based financing.
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The Practice of Musharakah Mutanaqisah at Malaysian Islamic Banks: An Empirical Review

By:
Prof Dr Zulkarnain Muhamad Sori
Prof Dr Shamsher Mohamad
Alam Asadov

CIAWM 2017
The demand for Shariah-compliant products and services from both Muslims and non-Muslims around the globe has contributed to the phenomenal growth of the Islamic finance industry for the last few decades. The cumulative growth rate of global Islamic finance assets was recorded at 17.3% per annum between 2009 and 2014. Proponents of Islamic finance postulate that the link to real economic factors with risk-sharing attributes, competitive returns with their conventional counterpart and the ability to share profit and loss (PLS) and buffer financial crisis are reasons for this rapid growth.

Among many permissible Islamic finance products, Musharakah or the partnership contract was put forward as a true representation of the PLS concept in the late 1970s. However, due to challenges to fully implement this type of contract in practice, practitioners have improvised a more practical version of the partnership contract termed Musharakah Mutanaqisah (MM) or Diminishing Partnership. Currently, Musharakah Mutanaqisah is applied in home financing by Islamic banks and proposed as a replacement for Bai Bithaman Ajil and Bay al Inah in Malaysia. Despite the increasing popularity of MM in home financing in the Malaysian Islamic banking industry, there are issues in the way the Islamic banks operate and report this mode of home financing in their annual reports. This is possibly due to convergence in practice as current MM products by Islamic banks closely resemble conventional home financing practices except for some contractual terms, thereby lacking the true spirit of the contract (Lung, 2013). Specifically, this lack of spirit is reflected through the use of interest-based benchmarks and absence of profit and loss sharing elements in the contract, as well as avoidance of any type of ownership risk (or expenses) by the bank and even reporting this transaction in their financial documents in a way that does not reflect the true nature of the contract.

A Brief Overview of the Musharakah Mutanaqisah (MM) Contract

The MM contract uses concepts of Musharakah (partnership), al-Bay (sale) and Ijarah (lease). In general, the partnership is operationalized as follows: It begins with two parties (i.e. the financier and the customer) purchasing a certain asset (e.g. a house) as partners. After the purchase, one of the parties (usually the customer) rents the portion of the asset that belongs to the other via a periodical payment (i.e. rent). In addition to the rent, a sale price is paid periodically (based on an agreed ratio), representing a purchase of the other partner’s (usually the bank’s) share of the property.

Any losses in value and maintenance expenses of the underlying asset in the contract are supposed to be shared in proportion to the partners’ shares in the asset, which is consistent with the principles of Musharakah. In addition to sharing profit or loss from the asset with the financier, the customer gradually acquires the partner’s share in the asset by making extra payments over the financier’s profit share in every period. With every subsequent payment, the profit part of the installment decreases as the financier’s share of ownership of the asset decreases. The partnership ends when the customer makes the last payment to the financier that covers both its profit and an amount equal to the financier’s remaining share of the asset.

The permissibility of the MM contract in Shariah is conditional upon the following principles (Osmani & Abdullah, 2010):

The goods must be present. The property which is not present at the time of transaction or pledged already, is not allowed to be used as collateral in a transaction.

The proportion of the profit must be specified, and the profit will be in proportion and not by amount of money. Both the financier and the customer must share the profit and loss of the property. Though the profit is distributed according to a pre-agreed ratio, the loss should be shared according to the proportion of each partner’s share in the ownership.

The Shariah advisory board must have the right to monitor the contract on a continuous basis.

The contract of partnership and the contract of sale should be done separately, and not collectively. Contracts underlying MM partnership could be combined in one package but should not be binding on each other. This means that partnership (Musharakah), sale (Bay) and lease (Ijarah) contracts should be separated from each other.

A binding promise can be taken from one partner to purchase the share of the other partner gradually.

“The MM contract uses concepts of Musharakah (partnership), al-Bay (sale) and Ijarah (lease)”
With effect from 01st January 2018, MFRS 9 will supersede MFRS 139. Reporting of equity instruments would be affected due to failure to comply with the ‘Solely Payment of Principles and Interest’ test as required by the standard. As a result, the regulators are looking for the best solution for this dilemma. Based on our other research, we recommend that the reporting of equity based instruments should be done through ‘Fair Value Through Profit and Loss’ by having a separate item labeled as Investment in Musyarakah.

None of the parties have the right to acquire the other’s share at cost price. The price paid should be either the market price or the price agreed at the time of the sale.

Relevant Standards for Reporting Musharakah Mutanaqisah Financing
MM financing is a contract of partnership to jointly own an asset between a customer and an IB. Subsequent to the acquisition of the asset, the bank leases its share in the asset to the customer at a certain lease payment. Based on the nature of the transaction in practice, few accounting treatments, namely (i) revenue recognition; (ii) initial recognition of the financial asset; (iii) assessment of financial assets’ impairment are documented based on guidelines by MFRS 15 (Revenue from Contract with Customers), MFRS 117 (Lease), and MFRS 139 (Financial Instruments: Recognition and Measurement).1

Accounting Treatment for Revenue Recognition
Regardless of the type of Islamic financing, it is necessary to document the banks’ profit based on certain set standards. But, there is no set “Islamic” standard for profit estimation and reporting in MM contract. Consequently, the Islamic banks apply the conventional banking effective interest rate method (except that there is no compounding of interest in overdue situations).

Since MM financing involves a lease contract, the IB’s ownership in the asset will be leased to the customer. Islamic banks have to split the monthly lease payments (i.e. minimum lease payments) into two portions, namely the profit portion (finance charge) and payment of principal (i.e. reduction of the outstanding liability). Though the IBs claimed that the bank portions are leased to the customer, the documents showed that IBs did not follow the leasing standard requirements (MFRS 117). The leasing standard requires separate disclosure under different title. In practice, IBs document MM in the same group as other type of financing under MFRS 139

1 With effect from 01st January 2018, MFRS 9 will supersede MFRS 139. Reporting of equity instruments would be affected due to failure to comply with the ‘Solely Payment of Principles and Interest’ test as required by the standard. As a result, the regulators are looking for the best solution for this dilemma. Based on our other research, we recommend that the reporting of equity based instruments should be done through ‘Fair Value Through Profit and Loss’ by having a separate item labeled as Investment in Musyarakah.
that is the ‘Financing, Advances and Other Financing’ classification’.

Review of financial statements reveals that nine out of sixteen (56%) IBs offered MM financing to their customers and all of them declared that their revenue recognition was based on the ‘effective profit rate method’. It was observed that the IBs that offered MM financing, offered it as “a joint ownership of the MM asset with their customer, and subsequently lease their equity or share of the asset on the basis of ijarah”.

The above finding raises ambiguities regarding the way MM financing contracts are operated as lease (ijarah) contract in practice. In context of MM home financing, ijarah usually refers to lease and separate sale (bay) transaction. Since financing ijarah combines both lease and sale contract together, IBs use Effective Profit Rate Method (EPRM) to split the periodic payment made by the customer into payment of principal and profit of financing. The use of an ijarah contract also eliminates the musharakah features of the financing product and the transaction is documented as a common debt-based instrument.

Recognition of Financial Assets
In MM financing, the IB enters into an agreement to jointly own an asset (or a house) and makes capital available to the partnership. The bank owns a sum of equity in the asset or the portion of the bank’s ownership of the underlying asset. The initial step is to calculate the fair value of the asset, where the amounts of any preliminary expenses (such as a feasibility study or legal documentation charges) that bring the asset into working condition can be capitalized in the value of the asset (Paragraph 43, MFRS 139). It is important to note that FAS 4 of AA0IFI disallows capitalization of these cost elements unless agreed by both partners. Indeed, as mentioned earlier, IBs lease their ownership in the asset (equity/share of the asset) to the customer subsequent to its acquisition under the MM financing. Thus, it is normal practice for IBs not to recognize the leased asset in their book and the customer would normally recognize the value of the asset in their book [if they are a business entity] due to consideration of the ‘substance over form’ principle. This is further evidenced by registration of ownership under the customer’s title as a beneficial owner with the land office and relevant authorities, and the IB will only claim ownership rights in the event that the customer defaults on the lease payment.

It is important to note that through the use of an ijarah contract, IBs circumvent various Shariah issues in MM financing. Issues such as shared Takaful expenses, continuous periodic fair value assessment and distribution of price variation as a result of price increase or decrease in fair value assessment, and the asset’s fair value due to early termination of the MM financing contract, are no longer relevant in MM financing.

The findings reveal that all nine IBs complied with MFRS 132 and MFRS 139 and disclosed their MM financing under the classification of ‘Financing, Advances and Other Financing’. The implication of this practice is that the asset is not subjected to a depreciation and impairment test. Furthermore, it is evident that periodical fair value assessment and distribution of variation of the asset’s value (either upward or downward) were not considered in practice. However, in practice, IBs periodically assess the impairment status of their ‘Financing, Advances and Other Financing’, where uncollectible financing would be written off from the account. Institutions that adopted the AA0IFI financial reporting regime reported this transaction differently, where, IBs recognized MM transaction as ijarah assets in their book and subsequently provide the relevant estimate of depreciation and impairment of the asset.

Disclosure Requirements
The objective of MFRS 7 is to provide relevant information to users on the significance of financial instruments to the financial position, performance and cash flow of the respective IBs.

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2 Due to the Shariah compliance requirement of Islamic banking business, the term “Financing, Advances and Other Financing” is used as a variation of the original classification of ‘Loan and Advances’ as stipulated in MFRS 139.
“MM financing is a contract of partnership to jointly own an asset between a customer and an IB.”

Although the MM financing is claimed as a joint ownership with profit and risk sharing features, the use of the Ijarah contract eliminates the unique features of MM financing. Based on the ‘substance over form’ principle, the substance of the transaction (or economic reality) indicates that the MM asset is under customer custody and they would be held responsible for the state of the asset. Furthermore, the MM asset is registered with the authorities under the name of the customer and the asset is charged (as collateral) to the bank. From the government’s perspective, it is clear that the IB is not a registered owner of the asset except for their claim to the MM asset that is being charged as collateral. Above all, IBs in Malaysia use accounting standards on financial instruments to account and report the MM financing.

**Conclusion**

In practice, MM home financing is a close replica of the conventional home financing. The payment schedule of MM financing is calculated based on the effective profit rate method and the amount invested in the MM asset is disclosed as ‘Financing, Advances and Other Financing’. In MM financing there is supposed to be a gradual transfer of the asset at its fair value and this may result in variations from the actual projection of liabilities. However, the current practice shows that the IBs lease their ownership rights of MM financing under the Ijarah contract. And, the gradual transfer of the MM asset’s ownership over the tenure of the contract is just a myth. There is no accounting record for the gradual transfer of ownership.

The beneficial ownership of the asset is transferred at the beginning of the contract and the IB only claims rights to the asset in the event that the customer fails to make the minimum lease payments. Indeed, the periodical payment of the account would only result in reduction of the customer’s outstanding value of the MM financing.

Since the MM contract is documented as an Ijarah contract, the accounting treatment for MM financing is inconsistent with those recommended by Shariah Scholars in the literature. The IBs did not report their share in MM assets and subsequent periodical fair value measurement and other related information. Since IBs recognized their revenue based on the ‘effective profit rate method’, it is pertinent for regulators to view this matter seriously and provide an objective solution. Perhaps relevant laws should be amended to allow joint ownership of MM assets and use of actual operating Ijarah for calculation of IB’s profit. Finally, it is not fair to call a financial arrangement MM financing if it is in essence another Ijarah transaction and the reporting is done using common debt-based instruments under the guidance of MFRS 139.
The last decade has witnessed significant growth of fund management companies in the Southeast Asian region, and Malaysia has shown immense potential in this area. The expansion of the middle income class, outstanding talent and abundant natural resources have contributed to this growth. Despite significant developments in the recent past, the mutual fund industry in Malaysia is relatively small compared with other markets in the region. A healthy growth of the fund market in Malaysia, particularly in the area of Islamic fund administration, requires a comprehensive financial ecosystem that is globally competitive.

The Securities Commission (SC) in their “Islamic Fund and Wealth Management Blueprint” released in 2017, among others, highlighted the possibility of positioning Malaysia as a global hub for Islamic fund administration. The Centre for Islamic Asset and Wealth Management (CIAWM) at INCEIF was invited to look into this strategic thrust. Initial discussions with the Securities Commission on this matter suggests for a more informative report to deliberate this initiative as a strategic response. As part of the CIAWM’s objective is to the Islamic is to the Islamic wealth management sector, it embarked on a research project to identify strategies to make Malaysia a global hub for Islamic fund administration. The research report will highlight not only the unique competitive advantages amidst the upgrading of all aspects that impact the financial ecosystem, but also strategies to position Malaysia as the global hub for Islamic fund administration.

A brief evaluation of the Malaysian position as a contender identifies significant gaps in comparison to the leading jurisdictions such as Luxembourg, Ireland, Singapore and Hong Kong. Specifically, improvements are required in currency control, corruption and overall market perception. However, if the focus is on Islamic fund administration, then Malaysia has some competitive advantage over the global fund centres in terms of a well-established regulatory and operational infrastructure for Islamic finance despite the required improvements suggested above.

Luxembourg for example, is possibly the most successful fund management centre outside the US. The main driver of their success is the regulator’s initiative to make it conducive for fund management. They are perhaps the most innovative country in legal entity structures, with very efficient approval processes and systems for fund management operations.

Another country that is considered a competitor in attracting Islamic funds is the UAE. The establishment of the DIFC (Dubai International Financial Centre) in 2004 was aimed
at positioning the UAE as a global leader in Islamic fund and capital market management. The systems in place and the success of the DIFC over the last decade indicate that Malaysia has much to learn from DIFC. The DIFC, within a dedicated duty free zone, offers a unique one-stop centre that includes providing office space for the financial services industry. Therefore, further analysis of the gaps in offering is expected to provide clarity to a strategy for making Malaysia a global hub for Islamic fund administration.

In the preparation of this research report, CIAWM has convened several discussions: both with industry and regulator to gain a holistic and practical views on this initiative. The objective of the industry-based discussion was to ascertain the views of the Industry players (domestic and foreign funds) in achieving this objective. The gaps that need to be addressed to develop Malaysia as a global hub for fund administration were highlighted from the Industry perspective. In the gaps identified, there were issues that concerned the regulators, and consequently discussions were held with regulators to get their views on the related issues raised by the Industry. The report also focuses on the gaps between what is currently offered internationally and what it will take for Malaysia to effectively compete with these global fund administration centres. Among others, we postulate that the regulatory, tax and administrative infrastructure are the main concerns of the Industry that need further deliberation to help formulate effective operational guidelines to achieve this objective.

The discussion with invited Industry players was held on 18th of January 2018 at Majestic Hotel, Kuala Lumpur. Fifteen participants included representatives from various organisations such as BNP Paribas, Amundi Islamic, PMB Investment, Standard Chartered Bank, and CIMB Islamic. The key focus areas of discussion were: Cost of fund administration, regulation of financial services and the financial ecosystem in Malaysia as per responses and published reports on the subject matter. However, several more issues raised by the participants’ concerned matters on custodian, regulation and currency controls in administering funds. Two discussions were also held with regulators on this issue in December 2017.

To acquire further views and insights, a conference with the theme ‘Malaysia as a Global Hub for Fund Administration’ will be organised in March 2018. Invited speakers from global financial centres are expected to share their views on this initiative. The research report that will highlight the strategies to position Malaysia as the global hub for Islamic fund administration will be launched at the conference.
Shariah and Socially Responsible Investment (SRIs) in the US:
Are Investors in these Portfolios Disadvantaged?

By:
Dr Zaheer Anwar
In recent years, there has been a notable increase in investor consideration for religiosity and/or ethics in investment decisions making it a class of investments in its own right and an important input in portfolio selection decisions. Investment decisions are governed not only by factors including investor anticipation of future economic, geo-political trends, social changes and investment timing but also religion or belief system. The religiosity and/or ethical practices prompt investors to discard so-called ‘sin stocks’ and limit their investment horizons to permissible investment alternatives. These faith-based investments have emerged in two prominent forms, namely Islamic or Shariah-based investments and Socially Responsible Investments (SRI). For the Shariah-screened portfolio, the class of assets and the securities in each selected class are subject to Shariah requirements. These requirements prohibit charging interest on loans, gambling and trade of impermissible items like liquor, pork and other Islamically prohibited items, and also imposes restrictions on the level of debts in financing and investment.

The history of SRI or ethical investing dates back to the start of the twentieth century\(^1\). Ethical investors are motivated by social, environmental, and ethical considerations in their investment decisions. They apply a set of investment screens to include or exclude assets based on ecological, social, corporate governance or ethical criteria. The growing importance of faith-based investments can be judged by the significant increase in the overall industry size. The Islamic finance industry has observed a double digit compound annual growth rate (CAGR) of 17% between 2009 and 2013 and the size of industry is still expanding both in terms of numbers and geographical locations\(^2\). In the same manner, the volume of assets acquired through socially responsible investing strategies stood at 8.72 trillion USD in 2016 and the number is expected to further increase in coming years\(^3\). There is potential for further growth for these faith and ethical based investments, since religious or ethical values are becoming a matter of concern to most investors. This is true, even if they have to trade-off with lower risk-adjusted returns compared to returns on conventional investments with similar risk.

Faith-based investment styles create several challenges for investment managers. To begin with, the universe of stocks for faith-based portfolios is restricted. Hence, it is probable that these portfolios may underperform as many attractive investment opportunities will be forgone due to religious or ethical restrictions. The literature on performance of faith-based portfolios is inconclusive. It is therefore pertinent to identify whether ethical and religious beliefs lead investors to bear additional costs. This article summarizes the findings on a comparative study of risk and returns of Shariah compliant and SRI firms in the US. Three portfolios of stocks were analysed:


The (possible) variance in idiosyncratic risk and performance patterns among the investment classes were for between 2006 and 2015, to allow evaluation of the risk-return trade-off for crisis and non-crisis periods. To estimate idiosyncratic risk and risk-adjusted return performance, three different ‘factor models’ were applied, namely the Capital Asset Pricing Model (CAPM), Fama-French Model (FF3) and Carhart (CRH4) Model. The portfolios were formed using i) Equally Weighted Portfolio Strategy, giving equal weightage to
every stock irrespective of its market capitalization and resulting in higher portfolio volatility owing to the higher representation of small cap stocks that are considered riskier and ii) Capitalization Weighted Portfolio Strategy, giving representation to stocks with respect to their market size and expected to be lesser volatile due to their higher representation of more seasoned companies.

The results revealed some important insights. It had been observed that for equally weighted portfolios, idiosyncratic risk was observed for all the portfolios. All three portfolios had positive alphas, implying that they performed better than the market. The Shariah portfolio recorded lowest unsystematic risk and lowest risk-adjusted return. The sample portfolios possessed higher-than-market systematic risk which was compensated by positive alphas, and small stocks provided the primary source of return for all the three portfolios. The returns for market and SRI portfolios were generated from large and seasoned firms (value bias) whereas the returns for the Shariah portfolio were largely from growing companies (growth bias). The momentum factor coefficient showed that the positive alpha was not the result of the momentum strategy i.e. buying past year winners and selling past year losers.

For capitalization-weighted portfolios, all the portfolios had negligible idiosyncratic risk but negative Jensen’s alpha implying that they underperformed the market. There was a very small difference in the magnitude of Jensen’s alpha for the sample portfolios. The market beta for these portfolios was lower than market, and justified their negative alphas. The size premium was positive for market and SRI portfolios, implying that the return for these portfolios came from small capitalization stocks whilst it was negative for the Shariah portfolio, implying that the return for this portfolio was mainly earned from large capitalization stocks. The values versus growth premiums were negative, implying that the returns were mainly from large and seasoned companies. Finally, the momentum factor was negative and very low, implying that no momentum strategy was meaningful. In summary, it was revealed that for both equally-weighted and value-weighted portfolios, the performance of the Shariah portfolio was inferior to the other two portfolios.

The findings provide some insights to the literature on the investment industry in the US. Shariah compliant firms recorded higher systematic risk possibly owing to their suboptimal capital structure. The faith-based investment style seems to be disadvantaged, though remaining viable in the long run. For capitalization-weighted portfolios, investors holding screened (religious or social beliefs) portfolios earned equal risk-adjusted returns, but were exposed to higher market risk. Hence, the faith-based investors who want to design their respective portfolios to achieve diversification and earn risk-adjusted returns at par with market should be prepared for higher market risk when investing in value-weighted portfolios.

Finally, it appears that unlike popular argument that Islamic finance can offer alternatives to non-Muslim investors seeking ethical investment avenues, SRI investors in the US seeking investment in Shariah portfolios as an alternative to SRI investment will bear increased cost in the form of higher systematic risk.
The Islamic Social Finance & Investment Imperative

By: Assist Prof Dr Ziyaad Mahomed

CIAWM 2017

29 CIAWM 2017
The rapid growth of global Islamic wealth and asset management has contributed to the establishment of a niche market based on the Islamic finance paradigm of interest-free, transparent, profit and loss sharing and mutually beneficial contracts. However, Islamic wealth and finance has been criticized for converging into conventional practices rather than its core principles of socio-economic empowerment and justice. The capitalist attributes of profit maximization without the ethical and moral boundaries has pervaded this industry that was supposed to espouse the ethical and socio-economic tenets as its value propositions for its future growth and survival. There is an emerging trend of Islamic social finance and investments imperative in the industry to meet the growing global demand for ethical investments.

We are in a new era in Islamic finance, driven by a global appetite for socially responsible and ethical investment created by the hype from the UNPRI and the more recent UNSDG 17. Reports by the World Economic Forum in 2011 and ‘SRIs & the case for Islamic Investment Funds’ in 2015, indicate that a paradigm shift in investment mindset is observable through divestments from fossil fuels to the funding of ethical, sustainable and good governance corporations. Between 2012 and 2014 alone, responsible investment grew by 76% in the United States, to approximately USD6.57 trillion or +20% of all assets under management. Doing ‘good for the society’ seems to be the new investment mantra, where community investment is also on the increase (54% growth observed between 2010 and 2014 in the US). Rising income inequality and mass migrations due to natural disasters, war and political crises have increased substantially over the last decade and the need to do good for the society. Therefore there is a need for sustainable measures (i.e. investing responsibly in real economic activities that are sustainable and socially responsible) to provide a more balanced socio-economic balance to mitigate this growing socio-economic crisis.

Arguably, the two most significant trends of increasing application of advanced technology and the interest in sustainable investments have significantly contributed to the global growth of Islamic social finance and investments. Regulations that defines the parameters of application are now in place to enable the success of these initiatives by capable participants. Their impact on the Islamic finance sector has been primarily positive as the social impact and real economy-linked transactions provide clear evidence of socio-economic empowerment and justice.

Islamic Wealth Management going ‘Green’

The global move towards SRI (socially responsible investment) and ESG (ethical, social and governance) investment has supported the triple bottom line measurement for responsible companies. The Islamic finance philosophy of a sharing economy envisages a financial system that supports a real economy rather than creating an unsustainable, superficial wealth cloud from a financial system that is created in and of itself. In this quest for socio-economic balance and reduced income inequality, the most recent trend is marked by the rise of sustainable banking that places people and planet before profits. As humanity is becoming more aware of the impact of its use of resources and short-term wealth goals, ethical finance and investment is increasing exponentially (more than 30% of global assets are in SRI at the beginning of 2017). Islamic finance and banking is based on an ethical premise and therefore expected to significantly support the emergence of value-based banking and intermediation over the next 5 to 10 years.

Earlier efforts in ethical investment raised the ire of return-seeking investors as ‘ethical’ was synonymous with welfare handouts, translating into the sacrificing of returns for the benefit of ‘doing good’. In fact, research indicates that performance of ethical investment post-2007 has been either on par or better than traditional investment. A Sharpe-adjusted return comparison attests to this:

![Sharpe Ratios Overall Islamic/Ethical vs Market](chart)

<table>
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<tr>
<th>Sharpe Ratios Overall Islamic/Ethical</th>
<th>Market</th>
</tr>
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</table>

1 The Six United Nations Principles for Responsible Investing
2 The Seventeen United Nations Sustainable Development Goals
3 Published by the Centre for Islamic Asset and Wealth Management at INCEIF
It seems that investing responsibly is actually profitable, even in the short-term. The spin-off over the longer term is significantly profitable as the economy grows and more participants populate various strata of the financial power index, ultimately generating more wealth and prosperity for all.

**Value-Based Intermediation**

Markets are beginning to respond to calls for financial services that are responsible and provide positive socio-economic impact. For example, the environmental organization Greenpeace, documents their youtube campaign exposing Banco Santander’s loans of GBP400 million to a logging company expanding its operations in Indonesia. After 3 million views in just 2 days and subsequent public protest, the bank announced within 48 hours that it would no longer lend to the company and that future lending would be based on new sustainability objectives.

Malaysia’s value-based intermediation strategy, driven by Bank Negara Malaysia [regarded as a global exemplar in the dual-banking system] is expected to move the Islamic finance industry into the next phase of sustainable, long-term economic development. The industry is expected to intensify its distinction and personify its existence through value-based intermediation or VBI. Built upon the pillars of entrepreneurship, community empowerment and self-governance, VBI promotes innovation, efficiency and transparency in a substantive ecosystem. Since Islamic finance already echoes these principles, it is a natural vehicle for the sustainable and socially responsible finance paradigm.

**Islamic Social Finance**

The more traditional methods of Islamic social finance have a long history of contributing to the development of Islamic nations. Zakat [alms-giving], waqf [endowment] and sadaqah [voluntary charity] have been used to provide for the basic means of livelihood for the poor and destitute albeit in a mostly informal structure. However, it is envisaged that the future application of these instruments will be exceedingly sophisticated, addressing the existing challenges in calculation, poor collection mechanisms and inefficient distribution channels. The skepticism that zakat payers and waqf donors justifiably emphasize can be dealt with using advances in technology such as the blockchain approach. It is now not difficult to imagine that zakat payment for example, can be calculated and made using smart apps that would present options to payers based on their personal preferences. For example, a zakat payer that would like to see his/her funds being utilized for specific projects, emergency relief or water and sanitation may be presented with several initiatives from various reputable NGOs, together with an independently assessed benefit or efficiency rating. Then using token technology, payees would be linked via unique id’s to the system, with potential to verify that ownership has been transferred (a requirement in zakat) and that the funds have been disbursed correctly. This has the potential of reducing bottle-necks in zakat distribution and ensures that the deserving recipients benefit from these contributions. It also encourages NGOs to enhance the efficiency and the socio-economic impact of their projects.

International organizations such as the IFRC (International Federation of Red Cross and Red Crescent Societies) and UNDP (United Nations Development Program) are actively considering Islamic finance solutions to mitigate the funding gap for social development and emergency relief. With regards to research and thought leadership in Islamic finance, the International Centre for Education in Islamic Finance based in Malaysia (INCEIF), has actively embarked on initiatives to encourage policy change to directly impact the social well-being of the society by utilizing Islamic finance percepts.

Islamic wealth management is at an opportune time to actively pursue sustainable investments and social finance in consonance with the global resurgence towards a more equitable socio-economic existence, the core principle of Islamic social finance. We hope that Islamic social finance will significantly contribute towards a more holistic approach in mitigating the global income inequality gap and gradually migrate into a paradigm of human excellence rather than just human survival.
STAY AHEAD BY DIVERSIFYING YOUR KNOWLEDGE

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Together, we can be the catalyst of change to bring the knowledge of Islamic Finance to new frontiers.
CRYPTO MANIA: THE SHARIAH VERDICTS
The 17th century was witness to the Dutch Golden Age, the leading global economic power at the time. It was also the period of what was soon referred to as ‘Tulip Mania’ for what is considered the first recorded speculative bubble that collapsed in 1637. Many analysts find a stark similarity between tulip mania and the dramatic rise of cryptocurrency value in 2017. Tulip bulbs became fashionable status symbols, and although having weak fundamentals, reached exorbitant prices. Bitcoin’s dramatic 1,500% increase in 2017 alone, attracted a significantly large group of speculative investors to benefit from what many see as an unhinged gamble on what has gained popularity, not only as decentralized ledger tokens but also with potential links to laundering activity. Most central banks and regulators have exercised caution by warning users of the high levels of risk but have conditionally legitimized its use. Some however, have banned it entirely.¹

The pertinent question raised at forums and conferences recently is the Shariah legitimacy of cryptocurrency, as Muslim investors intend to take advantage of the unexplained increase in its value. This brief article reviews the mixed Shariah views on cryptocurrency. These views are expected to become more lucid once the fundamentals and practice of cryptocurrency are better understood.

What is Cryptocurrency?
Digital cash and payment through ‘electronic’ money has been around since computer systems became the mainstay of the typical banking environment. However, since this relies on a payment network, the infrastructure required to manage payments and avoid multiple spending using the same funds has always been costly and managed through a centralized banking network. A central server therefore, ensures that funds are spent only once. This also means that society must transact based on regulated or controlled precepts that some argue, may be used to manipulate the value of currencies and the wealth of individuals. If individuals were able to transact freely between themselves through a ‘peer-to-peer’ network, this would allow society itself to determine the value of their currency. This would require a database that is able to record individual transactions with levels of encryption that would make it impossible to manipulate, steal, amend or erase. This has given rise to blockchain technology that achieves all these goals and more, providing argument for legitimacy of an instrument that can be recorded and recognized as a digital medium of exchange, a virtual currency or simply: cryptocurrency. Here, the ‘crypto’ refers to the encryption or cryptography that the instrument is built on and then added to a blockchain, whereas ‘currency’ is the recognition amongst its users as a medium of exchange or a store of value represented by the ownership of coins or tokens.

How are coins created?
Most cryptocurrencies restrict the total supply of tokens, however, accessing or creating new tokens requires a specific process. ‘Mining’ is the traditional method for creating Bitcoin, the most popular cryptocurrency to date. Since every transaction, once confirmed by the transacting parties, is broadcasted on the network, it still requires confirmation by the network to be added to the blockchain. Simply, if Ahmad transferred 10 Bitcoins to Ismail and both parties approved/confirmed it through a digital sign-off, then this would still need to be confirmed by the network so that it may be added to the global database (based on blockchain). However, only miners can confirm the transaction. Once confirmed by a miner, the transaction is added as a node to the blockchain and becomes a permanent, immutable record for all to see. ‘Miners’ are required to solve a cryptologic puzzle or an algorithm and are paid for their effort with tokens or coins. Bitcoin for example, uses the SHA 256 Hash algorithm that requires miners to find the output of a cryptographic function or a hash.² Miners compete to solve the puzzle and successful miners build a block to add to the chain once completed, receiving a specific number of coins in exchange.

<table>
<thead>
<tr>
<th>Period</th>
<th>Dollar Change</th>
<th>Percent Change</th>
</tr>
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<tbody>
<tr>
<td>Jan 2018</td>
<td>-$1,264.45</td>
<td>-7.82%</td>
</tr>
<tr>
<td>December 2017</td>
<td>+$0.64</td>
<td>+0.00%</td>
</tr>
<tr>
<td>Previous 6 months</td>
<td>+$12,542.09</td>
<td>+528.76%</td>
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<tr>
<td>Last 1 year</td>
<td>+$14,000.52</td>
<td>+1,532.58%</td>
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<tr>
<td>Last 2 years</td>
<td>+$14,464.90</td>
<td>+3,220.56%</td>
</tr>
<tr>
<td>Last 5 years</td>
<td>+$14,900.28</td>
<td>+108,208.25%</td>
</tr>
</tbody>
</table>

¹This list is not exhaustive, however: Bangladesh, Nepal, Kyrgyzstan, Ecuador, Bolivia and Algeria have prohibited the use of Bitcoin.
²This is referred to as ‘Proof of work’.
Tracking Bitcoin’s price movements over the last 5 years

Interestingly, articles in the Economist in December 2017 and January 2018 note that Bitcoin as a digital currency does not possess the trait of being a store of value due to its highly unpredictable nature (it is not uncommon for it to change up to 20% in value within an hour). The article reiterates the fears of laundering by regulators as Bitcoin can move across borders and currency controls with an internet connection, and the potential systemic risk to economies that it poses should something go wrong. This is not unfounded, especially since investigations are underway in the US on accusations that Bittrexex, a cryptocurrency exchange, has been manipulating the astronomical rise of Bitcoin using another cryptocurrency called Tether, creating an artificial bubble that has begun to burst (Bitcoin lost more than half its value by the end of January 2018). The same exchange was hacked in 2016, losing almost 200,000 Bitcoins in the attack.

What is the Islamic perspective on cryptocurrencies?

There are three particular dimensions that most Shariah verdicts have considered:

- The nature of the underlying instrument:
  - Is Cryptocurrency Maal (wealth)
  - Passing the Shariah filter of permissibility
  - The view of the Maqasid al Shariah
  (objectives of the Shariah)

In the first, the nature of the underlying instrument, contemporary jurists have offered verdicts primarily based on their recognition or definition of cryptocurrencies from a Shariah categorization perspective. This is logical as Islamic law has specific rulings for the way currency or money may be treated. For cryptocurrency to be considered valuable wealth/property or maal mutaqawwam, the jurists argue that it should be permissible (halaal), recognized through societal consensus as a store of value. To define its nature as maal, it would need to fulfill the following attributes:

- Having commercial value
- Capable of being owned and possessed;
- Ownership must be transferable;
- Capable of being stored;
- Beneficial/valuable in the Shariah.

We now briefly consider the opinions issued by contemporary scholars on cryptocurrency and Bitcoin in particular.

South African Scholars including Mufti Taha Karaan [Mufti of the Muslim Judicial Council] have deliberated on whether Bitcoin is an acceptable form of maal and whether it falls into the category of goods (urud) or currency. The conclusion by most is that it has already been accepted as maal through general social concurrence, irrespective of regulatory acceptance. The fatwa-issuing body of the well-known South African Islamic seminary, Darul Uloom Zakariyya, concurs with the position that Bitcoin is maal and hence permissible for trade. Another prominent South African Mufti - Siraj Desai - also submits that Bitcoin is valid for trade as it represents real money. His argument is that real money was used to purchase the coins and they are again redeemable into cash, making them permissible for ownership and trade. The Scholars at the Majlis al Ulama (South Africa) however, reject the notion of Bitcoin being recognized as money and categorically emphasize that it is not currency at this stage, although it may be in the future. In support of their view, they quote UBS Executive Axel Weber who stated: “In my opinion, bitcoins are not money.”. The Majlis submit that currency in Shariah is only that which is recognized by government as legal currency6. They subsequently prohibit the owning and trade, as according to them, it is gambling.

A fatwa issued by Professor Monzer Kahf considers Bitcoin specifically, a legitimate medium of exchange. He states: “Like any other currency it is money within its community and exchanging it with other currencies is definitely subject, in my opinion, to some conditions of exchanging currencies.”. However, he also explains that “until it becomes traded in the open market chances of manipulation are high and my confidence in it is low.” It should be noted that this opinion was provided in 2014, long before Bitcoin’s dramatic rise.

With respect to the second and third dimensions, passing the filter of Shariah permissibility and fulfilling the objectives of the Shariah, the instrument is tested against the basic prohibitions pertaining to the law of transactions and its overall benefit to society. This includes the prohibition of riba (interest), gharar (uncertainty) and maysir (gambling). The majority of the views applying these filters are that of prohibition:

A fatwa from Turkey’s leading religious authority, Diyanet, in November 2017, declared Bitcoin un-Islamic, stating:

“Buying and selling virtual currencies is not compatible with religion at this time because of the fact that their valuation is open to speculation (excessive gharar), they can be easily used in illegal activities like money laundering and they are not under the state’s audit and surveillance.”

This was followed by a fatwa in December 2017 by a well-known Saudi Scholar, Assim Al-Hakeem who banned digital currencies in Islamic law due to their ambiguous (gharar) nature. In a similar vein, the Grand Mufti of Egypt, Shawki Allam, issued a fatwa in January 2018 banning the trading of Bitcoin as it causes harm to individuals, groups and institutions. He compared the trade in cryptocurrency to maysir or gambling which is prohibited in Islam. His fatwa considers virtual currency as impermissible since it is not accepted by legitimate bodies as an acceptable interface of exchange. He also stated that the “currency’s risk as well as its high profit potential undermines Egypt’s ability to maintain and

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3 It is generally accepted that prohibited items such as alcohol and pork do not hold value
4 Mejelle, Art 126
5 http://www.themajlis.info/21923/bitcoin-not-currency
6 http://lightuponlight.com/blog/fatwa-on-bitcoin-by-monzer-kahf/

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It seems that the Mufti has recognized Bitcoin as a currency but with high risk that lacks any state supervision, hence the prohibition*. In a separate ruling the Mufti’s counsellor Magdy Ashour, added that the currency is used to directly fund terrorists*. He also stated that since Bitcoin had no rules defined, the pillars of an Islamic contract were not upheld, making it impermissible. This is supported by Darul Iftaa of Deoband, a leading fatwa-issuing body in India, including a total of nine major scholars in the UK.

The verdict of abstention rather than outright prohibition is expressed by Shaikh Abdus Sattar Abu Ghuddah, the Chairman of the Shariah Board of the Albaraka Banking Group.

Those that have prohibited it have relied primarily on the nature of uncertainty and high levels of risk in value, tradability and security of cryptocurrencies. Others argue that these attributes can be afforded to any fiat currency, although not even fiat currency can boast the levels of the safety and transparency offered in the blockchain environment.

Conclusion
In summary, the understanding of cryptocurrency, its mining, tradability, security and systemic impact is evolving, and verdicts are expected to be more informed as cryptocurrency is better understood. Scholars serve as guides to the Muslim community and the responsibility of providing well-researched opinions is something that any sincere Scholar appreciates. This appreciation also extends to the implications of haram (prohibition) verdicts over those that suggest exercising caution or abstention.

The technology that most cryptocurrencies are based on—blockchain—however, may be considered a boon to the Shariah requirements of transparency and disclosure and enhance the notion of trust in exchange transactions and transfers. Perhaps it is blockchain then, that requires significantly more research rather than a Shari‘i deliberation on one of its by-products alone.

Finally, if we accept cryptocurrency as an asset/wealth/maal, then its implications on zakat and inheritance require Shariah deliberation as well.

For the success of cryptocurrencies as an alternative to major fiat currencies, it would have to prove itself through wider Shariah and conventional acceptance, application and regulation. Inevitably, time will provide the buffer for more informed verdicts on crypto-mania.

<table>
<thead>
<tr>
<th>Fatwa/Opinion Issued by</th>
<th>Verdict</th>
<th>Reasons for Verdict</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taha Karaan (Mufti) [South Africa]</td>
<td>Permissible (Mubah)</td>
<td>Based on istilah (social concurrence) and ta‘amul (common usage) that it is maal, allowing owning, trading, etc. However, not necessarily currency.</td>
</tr>
<tr>
<td>Darul Iftaa, DUY [South Africa]</td>
<td>Abstain until further clarification acquired (Mamnoo’)</td>
<td>May be linked to a pyramid scheme; Even if determined as currency, should not be a means of one’s livelihood as jurists allow trade of currency as necessity only.</td>
</tr>
<tr>
<td>Monzer Kahf (Professor)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Siraj Desai (Mufti) [South Africa]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Darul Ihsan (South Africa)</td>
<td>Abstain/impermissible (Mamnoo’) but not outright prohibition</td>
<td>Excessive uncertainty (gharar); Security risk (khatar); It is unlike currency which is regulated, legal tender.</td>
</tr>
<tr>
<td>A S Abu Ghuddah [Shaikh] [Syria]</td>
<td>Abstain/impermissible (Mamnoo’) but not outright prohibition</td>
<td></td>
</tr>
<tr>
<td>Diyanet (Turkey)</td>
<td>Un-Islamic at this time (Mamnoo’)</td>
<td>Excessive gharar; Can easily be used in illegal activity.</td>
</tr>
<tr>
<td>Majlis al Ulama (South Africa)</td>
<td>Prohibited (Haram/Tahreem)</td>
<td>Not currency since it is not legal tender; Current decentralized validation (mining) based on gambling (Wifaqul); Highly unstable, making it too risky; Trading digital currency is like trading trades (Deoband); Funds terrorists (Ashour).</td>
</tr>
<tr>
<td>Wifaqul Ulama [UK]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(8 Scholars of the United Kingdom)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Haitham al Haddad [Shaikh][UK]</td>
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<tr>
<td>Darul Iftaa, Deoband (India)</td>
<td></td>
<td></td>
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<tr>
<td>Shawki Allam [Mufti] [Egypt]</td>
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<td>Magdy Ashour [Egypt]</td>
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<tr>
<td>Assim al Hakeem (Saudi Arabia)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Summary of Shariah verdicts by end January 2018

* http://english.ahram.org.eg/NewsContent/3/12/286399/Business/Economy/Bitcoin-trading-is-unlawful-pursuant-to-Islamic-Sh.aspx
An invitation to apply for the 2017 CIAWM scholarships was officially announced on the 28th June 2017 and a grace period of one month (until the 31st of July 2017) was given to INCEIF PhD students who qualify the set criteria to apply on online basis. Since 2013, BNP Paribas – INCEIF Centre for Islamic Wealth Management (CIWM) [now rebranded as Centre for Islamic Asset Wealth Management (CIWM)] since January 2016 to allow for wider scope of activities] has been awarding scholarships to deserving INCEIF’s PhD candidates. The qualifying criteria for application is that students have completed their course work and the Comprehensive Examination and currently preparing their research proposals. With the objective of promoting scholarship in Islamic asset and wealth management, preference is given to candidates whose research is in the area of Islamic Asset Wealth Management, and who have no other sources of funding. The scholarship covers the tuition fees for 24 credit hours for PhD by coursework or 42 credit hours for PhD by research and a monthly stipend of RM 1,500 for a maximum tenure of 18 months.

Since its inception in 2013, the Centre awarded scholarships to seven (7) students (until 2016). Three CIAWM scholars have successfully graduated in 2017 as listed below:

CIAWM Scholars Graduated in 2017

**PhD in Islamic Finance (by coursework and dissertation)**

Moutaz received his early education in Syria and obtained his Bachelor’s degree in Accounting from Damascus University in 2005. He completed his joint Master’s programme in Damascus University and Bordeaux IV, France, in Banks and Finance Management. His research is on The Competitiveness and Stability Relationship among Islamic Banks.

He is currently a Researcher at International Sha’riah Research Academy for Islamic Finance (ISRA).

**Mohd Moutaz Abojeib** 2013 Scholar

**PhD in Islamic Finance (by coursework and dissertation)**

A graduate of Damascus University with a Bachelor’s in Economics, Mazhar completed two diplomas in Islamic Funding and English language both in 2008. He then completed the Charted Islamic Finance Professional program and a Master’s degree in Islamic finance from INCEIF. The title of his research is Financial Performance & Macro Effect of Takaful Companies vis-à-vis Economic Growth.

He is currently working as Senior Lecturer at Universiti Kuala Lumpur (UniKL Business School).

**Mazhar Hallak Kantakji** 2015 Scholar
PhD in Islamic Finance (by coursework and dissertation)
Obtained his Bachelor in Economics from Damascus University in Syria, he pursued 2 Masters’ degrees both in Financial Markets from The Arab Academy for Banking and Financial Sciences in Jordan and Islamic Finance at INCEIF. His research topic is Determinants of Sukuk Credit Rating and Stock Market Reaction during the Shariah Governance Reform Period.

Mahmoud AlHomsi
2013 Scholar

PhD in Islamic Finance (by coursework and dissertation)
Obtained his Bachelor Degrees in Economics and Islamic Revealed Knowledge and Heritage from International Islamic University of Malaysia (IIUM) and he pursued his Master of Science in Finance in the same university. He is currently pursuing his PhD at INCEIF with the research titled The Effects of Financing / Loan Portfolio Diversification on Performance: Evidence from Islamic Banks

Mirzet Šeho
2017 Scholar
EVENTS IN 2017

ROUND TABLE DISCUSSION
MALAYSIA AS A GLOBAL HUB FOR FUND ADMINISTRATION
(Industry Key Players)

Held on 18th January 2017, 9am – 2pm, Majestic Hotel Kuala Lumpur 15 invited guests attended to contribute ideas for the discussion namely from:

1. PwC Singapore
2. PMB Investments
3. Saturna Sdn. Bhd
4. Amundi Islamic Malaysia
5. BNP Paribas
6. Maybank
7. CIMB Islamic Trustees
8. Standard Chartered
Accounting Issues in Islamic Finance Industry | 25th – 26th September 2017
Lancaster University, United Kingdom.
FIRST ROUNDTABLE DISCUSSION WITH SECURITIES COMMISSION MALAYSIA A GLOBAL HUB FOR FUND ADMINISTRATION (Regulators)

13th November 2017 | 25th – 26th Securities Commission, Kuala Lumpur

SECOND ROUNDTABLE DISCUSSION WITH SECURITIES COMMISSION AND MALAYSIA INTERNATIONAL ISLAMIC FINANCIAL CENTRE (MIFC) MALAYSIA A GLOBAL HUB FOR FUND ADMINISTRATION (Regulators)

14th December 2017 | Sasana Kijang, Bank Negara Malaysia, Kuala Lumpur
FORTHCOMING EVENTS IN 2018

1. MALAYSIA:
   The Potential Hub for Global Islamic Fund Administration Conference
   Proposed date and venue:
   28 March 2018 I Sasana Kijang, Bank Negara, Kuala Lumpur

2. WORKSHOP ON FINTECH:
   ITS IMPACT ON THE ISLAMIC FINANCE INDUSTRY
   Proposed date and venue:
   August / September 2018

3. FOUNDATION OF ISLAMIC FINANCE CONFERENCE 2018
   A collaboration between Sunway University and INCEIF
   Proposed date and venue:
   October 2018
Islamic Wealth Management
Theory and Practice

Foundations of Islamic Finance series
Edited by Mohamed Ariff, Chair of Economics and Finance, Sunway University and Shamsher Mohamad, Professor of Finance, International Centre for Education in Islamic Finance, Malaysia.

From an Islamic perspective, although the ownership of wealth is with God, humans are gifted with wealth to manage it with the objective of benefiting the human society. Such guidance means that wealth management is a process involving the accumulation, generation, purification, preservation and distribution of wealth, all to be conducted carefully in permissible ways. This book is the first to lay out a coherent framework on how wealth management should be conducted in compliance with guiding principles from edicts of a major world religion.

“This book is a welcome contribution to Islamic finance literature. As the global Islamic market continues to grow, strengthening capacity-building has become crucial to consolidate an all-encompassing ecosystem for shari’ah-compliant operations. The volume successfully addresses this need by shedding light on the rationales and tools of Islamic wealth management, where notably are the creation, enhancement, protection and distribution of wealth functional to market efficiency, but primarily conceived in the light of ultimate objectives of fairness, equality and economic justice.”

— Valentin Cattelan, IE Business School, Madrid, Spain

“It is a timely book on a much neglected area of the Islamic finance discipline. It contains 21 chapters ranging from wealth management to governance, to Islamic social finance, strewn together under 5 sub-themes. The book chapters combine both concepts and operational aspects of Islamic wealth management. The authors have done an excellent job in exploring each idea and concept thoroughly, and I highly recommend this book for academicians, scholars, practitioners, and policymakers.”

— M. Kabir Hassan, University of New Orleans, US

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