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Table of Contents

DCC-Garch Models Using Islamic Market and European Market Indices

***Dr. Sabbah Gueddoudj*[1]**

Abstract

The last financial crisis (2007-2008) raises the question of how European stock shocks are distributed and transmitted from developed stock markets to Islamic stock markets. More precisely, the problem related to Islamic finance or any other alternative finance is, whether the shocks to the volatilities in the asset returns constitute substitute or complement in terms of risks strategies. A good understanding of volatilities of asset returns is necessary to analyze and forecast domestic and international investors' portfolios. The cornerstone of the current paper is the analysis of the dynamic correlations between the European conventional financial indices (as a proxy for global benchmark) and Islamic indices. We have chosen European markets since most of the works on this topic have focused on the US market. We have used the Dynamic Conditional Correlations approach to detect any shifts in correlations between the different indices over a recent period (from 07/31/2007 to 08/25/2017). The period includes the most severe financial turbulences (2007-2011) in Europe. Two types of distribution have been tested namely Gaussian distributions versus t-distributions. The paper finds that European and Islamic indices are highly correlated. This point may be useful for the policymakers because of the contagion risk. The results are robust across different distributions and the model associated with t-distribution is more relevant.

Keywords: assets returns, Islamic market index, European conventional market index and dcc-garch model

Introduction

The dynamics of the financial markets are among the most complex economic phenomena. In fact, uncertainty controls this dynamic and plays a central role in most of the problems tackled by financial theory (Bollerslev *et al.,* 1991). Therefore, modeling forecasting exercises cannot be considered without taking into account the countless factors that influence the market. The asymmetry of information and the significant number of agents intervening and interacting with the financial landscape are the main factors influencing the market and making financial modeling difficult.

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This paper should not be reported as representing the views of the ENSTA-Paris Tech. The views expressed are those of the author and do not represent those of any institution the author are or have been affiliated with, such as Central Bank of Luxembourge, National Bank of Belgium, EDHEC, Jussieu University, Paris XI University (Orsay) or Paris I University (Sorbonne).

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However, the high frequency of financial crises, especially during the last decade (2000- 2011), raises questions about the reliability and relevance of existing financial models and their basic assumptions. These assumptions, in particular, the Brownian movement that conditions the normality of stock prices and the semi-strong efficiency hypothesis supported by Fama are restrictive assumptions.

Moreover, many hypotheses often accepted in financial theory are not relevant to answer the dynamics of financial time series. Firstly the assumption of normality is virtually rejected in most studies on financial assets (exchange rates, stock indices, macroeconomic aggregates, etc.). Many researchers have asserted empirically that the introduction of the standard Brownian motion generates an underestimation of risks. Consequently, several stock market shocks have occurred since the beginning of the 20th century although their probability of occurrence was practically zero. This is due to the shape of the Gaussian law (which characterizes the Brownian motion), extremely flattened at the extremities and whose tails are very thin, largely ignoring the extreme values (Walter and Véhel, 2002). All the basic underpinnings of these theories will be called into question because of their lack of realism and their incompatibility with the behavior of the financial series. Moreover, the inability of Gaussian modeling to predict the occurrence of crises and prevent the advent of extreme risks has called all the classic models of finance into question (Walter and Véhel, 2002; Wilson, 2004).

Another hypothesis empirically refuted is the properties of homoscedasticity. Homoscedasticity means that volatility is a constant variable over time. However, the fluctuations and upheavals that the financial landscape has experienced all along suggest a conditional volatility (ARCH) autoregressive effect present in the stochastic component of the financial series.

Given the imperfections in classical models, new mathematical models have been put forth to ensure optimal modeling of financial assets i.e. simple heteroscedastic conditional volatility models and generalized models (ARCH and GARCH) developed by Engle (1982). These models have the main advantage of taking into account essentially the variable temporal dynamics of volatility (heteroskedasticity) and also the leptokurticity of the returns, reflecting an excess of Kurtosis (coefficient measuring the flattening of distributions). This excess of Kurtosis is one of the indicators of non-normality.

New classes of models have been introduced, notably the extensions of the GARCH models, namely the GARCH exponential known as EGARCH and the fractional integrated GARCH known as FIGARCH.

ARCH and GARCH are symmetric models (in the sense that good and bad news have the same impact on future returns and therefore on volatility). Indeed, the asymmetric GARCH model or EGARCH was adopted when Black (1976) noticed that good and bad news have different impacts on volatility contrary to the GARCH model.

This phenomenon of asymmetry means that bad news tends to increase volatility to a greater extent than good news. This indicates the sensitivity of volatility to shocks.

The models described above are based on a univariate approach. There is no relationship between several financial assets. This may be limited to analyzing contagion effects during the financial crisis.

Currently, the improvement in econometric models is not sufficient to predict financial crises efficiently. The recurrence of crises added to the volume of enormous losses suffered by financial institutions around the world and raised questions about the way finance operates. The current financial system is the victim of large speculative drifts that have created explosive bubbles. The financial industry has also witnessed the birth of derivatives that generated excessive and reckless risk-taking.

Born in the 1970s, Islamic finance is currently gaining momentum throughout the world and is increasingly becoming a competitor of the conventional financial system. It has attracted the interest of a wide range of investors and also that of countries affected by the crisis who wish to revitalize their economies by allowing new avenues of financing. "The IMF estimates that the Islamic financial sector has grown by an average of 10 percent over the last decade and that the growth of the Islamic finance sector has averaged 15 percent since 2003, reaching \$ 500 billion at the end of 2006" (Brack, 2007). In addition to banking, Islamic finance has been able to expand into market finance activities, including fund management and index management. The first Islamic index was launched in the market in 1998 known as Socially Aware Muslim Index. Since then, the range of Islamic indices has been extended and Islamic index providers now offer a variety of Sharia indices.

Despite the remarkable expansion of Islamic finance due to a number of factors, most notably the influx of petrodollar and excessive liquidity of the Gulf countries, studies and research works aiming at quantifying the volatility and risks related to Islamic finance are very rare, especially in Europe. In fact, there are few studies that have attempted to grasp the dynamics of Islamic stock markets. This field of research is of major interest since it makes possible to provide tools to assist investment decisions in new financial products that are hardly known. In fact, investment decisions are made as a result of market assessment. Risk assessment and asset valuation are based on statistical models. Volatility remains one of the most widely used quantitative tools for assessing a financial market and measuring its stability.

To study the interactions between traditional stock markets and Islamic stock market, we employ a DCC-Garch model.

The paper is structured as follows. The second section is devoted to literature review. The third section provides information on the Islamic index and on preliminary statistics. The fourth section describes the research methodology (DCC-Garch models). The fifth section presents the main results based on the DCC-Garch model taking into account Dow Jones Islamic Market Index (DJIM), S&P Euro 75 (EUR) and S&P EUROPE 350 (EUR). The sixth section concludes the major findings of the study.

2. Literature Review

Islamic finance, which comprises banks, indices and funds, has often been ignored in the economic literature. There are several explanations of this fact such as the newness of the phenomenon and its size. Indeed, Islamic finance is a recent activity if we compare it with the traditional finance. According to some works, Islamic finance started during the 70's with the development of financial organizations like the Dubai Islamic bank, and it skyrocketed during the 90's (El Khalichi *et al.*, 2014). The economic literature for Islamic finance can be divided in two distinct approaches. The first one is mainly qualitative. We can cite the studies of Elgari (1993), Alhabsi (1994), Anwar (1995) or Ahmad (1997). Their works focus on practices and regulation of Islamic finance. In 2000, Naughton and Naughton proposed a pioneering analysis of Islamic stock market but it remains at a qualitative level. These studies contribute greatly in understanding the Islamic finance. Nevertheless, they remain insufficient in evaluating the impacts of such activity on economic growth and the interdependence between traditional and Islamic finances. Consequently, a quantitative approach is more suitable.

Concerning economic growth model, there are few studies describing the linkages between the Islamic finance sphere and real economic sphere. According to Goaied and Sassi (2010), the relationship between Islamic banks and development is not significant. They based their analysis on a GMM panel approach for the Middle-East and North Africa (MENA) region for the period 1962-2006. Barjas *et al.* (2010) also explored the link between Islamic bank and growth and concluded the same results except for the oil exporting countries. This result is not surprising and is common in financial literature since the link between growth and finance is not trivial. In fact, Furqani and Mulyany (2009) thanks to a VEC model and causality tests from 1997 to 2004 for Malaysia, demonstrate that GDP Granger causes growth of Islamic banks. Moreover in 2012, Abduh and Omar using an ARDL[2] framework from 2003 to 2010 for Indonesia have found a significant bi-directional relationship between finance and growth, which is in line with the traditional finance literature. Hakim Bm and Md Akther Uddin (2016) show that there is a solid and positive link between growth and finance for a recent period.

All these works focus on Islamic finance within Islamic countries and omit the cross- border linkages between Muslim and non-Muslim regions. To analyze the international impact, one of the most optimal variables is the stock market index.

The literature review comparing both Islamic and conventional equities is

[2] Auto Regressive Distributed Lag.

mostly based on US stocks markets. The financial crisis has increased the interest in studying ethical finance. The Sharia finance seems to be an excellent alternative to conventional finance. Nevertheless, it is possible to find some interesting on this topic before the recent financial crisis. Atta (2000) compared the performance of Dow Jones Islamic Index (DJIM) to market index and no-risk rate. He found that the Islamic index does not outperform and it brings more yields compared to a free-risk rate asset. Several works compare Islamic indices performance to other indices (Hassan, 2001; Tilva and Tuli, 2002; Hakim and Rashidian, 2002, 2004). All these studies conclude that the Islamic indices carry a lower risk than other types of traditional index. They also notice no direct link between traditional and Islamic equities. This point reinforces the idea of Islamic finance as a "safe" investment and rational choice during financial turbulences. This conclusion was relatively obvious before 2007.

In 2010, some works focused on the existence (or the non-existence) of contagion effect (Abdul Karim *et al.,* 2010). Using MGARCH DCC model, Rizvi and Arshad (2013) discovered that there is a weak relation between Sharia and conventional indices in the long run but Abu Bakar and Masih (2014) demonstrated that the Islamic indices are more correlated with the Western markets as compared to the Asian markets. To analyze the relationship between Sharia financial markets and US markets, Majdoub and Mansour (2014) ran different multivariate GARCH models and found a weak relation. Hengchao and Hamid (2015) found that the integration within the Asia-Pacific Islamic markets and conventional markets has arisen after the 2007 crisis. According to Saiti, Bacha, and Masih (2015), there is a contagion effect between conventional and Islamic stock index after the U.S. Subprime crisis.

During the recent decades, we have observed an increase in capital markets and this has been illustrated by a rise in financial assets correlations. This may at time raise the question of financial stability in Muslim countries since the risk increases with the degree of correlation between assets. Therefore, policy makers have to take into account this new challenge (Iqbal *et al.*, 2007 and 2010).

Most of the works take into account U.S. stocks index and until now it is not possible to reach a consensus between all these different works. Nevertheless, the most recent analyses note a convergence process between Islamic indices and Western indices.

To conclude this section, the Islamic finance-growth nexus and the Islamic indices performances are still causing a heated discussion and the literature related to Muslim finance is blooming.

3. Data Collection

The aim of this section is to present the database and some preliminary statistics. We describe and justify the selected variables to introduce in the DCC-Garch model. We use several statistical tools to analyze the process of each variable. Unit root tests and breakdown tests are applied to identify the variables' nature. There are 4 financial variables (Dow Jones Islamic Market Index (DJIM), S&P Global Property (US), S&P Euro 75 (EUR) and, S&P EUROPE 350 (EUR)) but the MGarch model takes into account 3 of them since the property index causality test is not conclusive.

We emphasize on the Islamic finance index since this variable is not sufficiently known in Europe. Before presenting the statistical results, we present the history and the mechanism of an Islamic index.

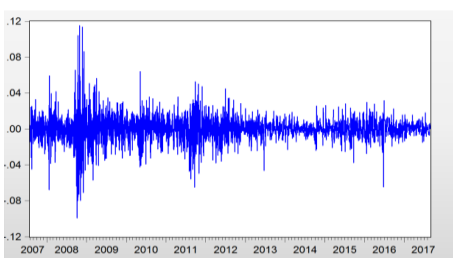
Modern Islamic finance began to develop in the early 1970's with the rise of religiosity in the Muslim world and the surge in oil prices. Islamic finance, based on the principles of Sharia which impose justice, fairness, and transparency, is distinguished from conventional financial practices by a different conception of the value of capital and labor (Chapra *et al.*, 2008 and Imam and Kpodar, 2013).

Historically, the first Islamic index was launched in the market in 1998 which is Socially Aware Muslim Index (SAMI). Since then, the main suppliers of classical indices have expanded their range and now offer a wide range of Sharia indices to support the accelerated development of Islamic Finance, in particular, Sharia Compliant funds. Nowadays, agencies, such as Standards & Poors, offer more than 30 Sharia indices. The Dow Jones Islamic Market (DJIM) is based on hundred capitalizations. All geographical areas, sectors of activity and, levels of capitalization are covered. The Sukuk market and the Sharia ISR indices are available. The majority of Islamic indices are based on benchmarks and their constructions are a parent index filter. Islamic indices use several methods of screening financial assets in order to include them in their selection (Rahman *et al.*, 2010; and Srairi, 2013). For instance, the Dow Jones Islamic Market Index (DJIM) is built on the prices of the 2700 companies, owned by the Dow Jones, but their activities regard the Sharia rules. The DJIM takes into account several criteria. The first one examines the firm's debt ratios: "the debt to assets". The second screening based on the level of non-exploitable interest income imposes a minimum level; "the Haram" share of income has to be withdrawn through a charity donation for example. In terms of liquidity, it is assumed that it is allowed for Muslim investors to buy the companies' shares but the purchase ratio does not exceed 45% of the total assets. The DJIM screening also defines that investors cannot buy securities with a rate of return defined in advance and guaranteed capital. Moreover, they are not authorized to invest in the shares of companies whose main activity is illegal. Besides, the Sharia Board of the index recommends introductions of firms with pro-environmental policies concerns, and/or humanitarian activities. In 2006, the Dow Jones and the Sustainable Asset Management group launched the Dow Jones Islamic Sustainability Index. The main purpose of this index is to specify investment criteria in line with Islamic finance criteria and sustainable development. Among the other main indices used in the market we can also cite examples such as Global Islamic Index Series, S&P500 Sharia, and FTSE Global Islamic Index Series.

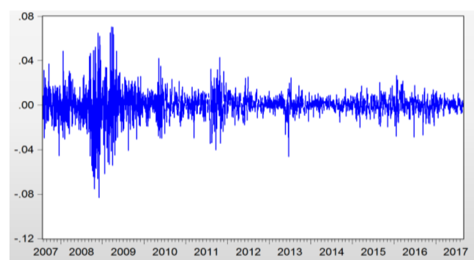
After the brief Islamic index presentation we select three other indices namely S&P Global Property (US), S&P Euro 75 (EUR) and S&P EUROPE 350 (EUR). We do not present them since they are famous but propound the rationality to introduce them in the model. The justification of analyzing the S&P Global Property (US) lays in the role of the real estate assets in the last financial crisis. We have also chosen to introduce European indices since most of studies on this topic are based on US indices (Rahman and Sidek, 2011; and Saiti *et al.*, 2014) and we notice a great progression of Islamic finance in Europe, in particular in UK and Luxembourg. Indeed, the UK has been the most active market for Islamic finance for years. Luxembourg is one of the main financial places in Euro zone for the Islamic finance industry. Its popularity comes from a competitive pricing, several incentives and a great access to the European market. Since 2002, Luxembourg is the principal actor in listing Islamic funds. Indeed, it is one of the great Islamic finance centers in Europe. Remember that the Luxembourg Stock Exchange was the first to introduce Sukuk in 2002. The Grand- Duchy of Luxembourg is also the first European member of the International Islamic Liquidity Management. According to European analysis (Di Mauro *et al.*, 2013), Islamic finance has been one of the fastest growing sector during the last few decades and the financial crisis amplified this trend.

The following Figures provide the return of the selected indices. Data have been based at 100 for the 7/31/2007 period. They are from the us.spindices website[3]. All variables have been log-differentiated to get the stationary properties.

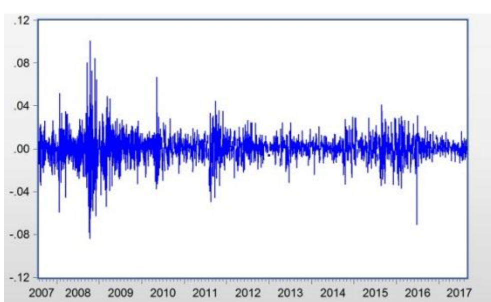
1-a/ DJIM



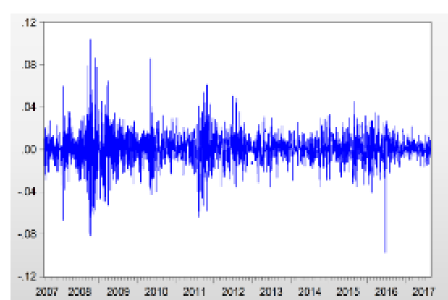
1-b/ S&P Global Property (US)



1-d/ S&P EUROPE 350 (EUR)



1-c/ S&P Euro 75 (EUR)



[3] https://us.spindices.com.

Figure1. Indices' Returns from 7/31/2007 to 8/28/2017 (daily frequency**)**

Source: Authors Calculations

The trajectory analysis demonstrates that the variable seems to be stationary. To assess this result, a Dickey-Fuller variant test is run. The following table 1 summarizes the unit roots results.

Table1

Unit roots' Results

t-Statistic	DJIM	S&P Global Property (US) Gross Total Return	S&P Euro 75 (EUR)	S&P EUROPE 350 (EUR)
Augmented Dickey-Fuller test statistic	- 54.20218	- 41.02574	- 46.43398	-46.28512

Notes: Test critical values at 1%, 5% and 10% are respectively -4.949133, -4.443649 and -4.193627.

The several indices' studies show common breakdown trajectories for the period 10/13/2008-11/20/2008 (see table 2). Therefore, the dating estimations seem to be consistent with the financial stress indices.

Table 2

Break Dates for each Index

Indices	DJIM	S&P Global Property (US) Gross Total Return	S&P Euro 75 (EUR)	S&P EUROPE 350 (EUR)
Break dates	10/29/2008	11/20/2008	10/13/2008	10/13/2008

These dates coincide with the Troubled Asset Relief Program (TARP) created by the Emergency Economic Stabilization Act1 (EESA) in October 2008[4] and the announcement of the Term Asset-backed Securities Facility (TALF) by the Federal Board in November 2008[5].

All mean returns are positive and the volatilities are higher for the S&P Euro 75 and DJIM. This latter result is not surprising since it is due to a less diversified portfolio on specific activities (Majid *et al.*, 2007; and Majid *et al.*, 2009). Moreover the mean returns are not high at all and small compared to the volatilities measured by standard

[4] "EESA was passed by Congress and signed by President Bush to address an ongoing financial crisis that reached near- panic proportions in September 2008" (Source: https://fas.org/sgp/crs/misc/R41427.pdf).

[5] https://www.federalreserve.gov/newsevents/pressreleases/monetary20081125a.htm.

deviations. The skewmess values are negative except for the DJIM variable. This means that for the Islamic index, the positive returns are more frequent than negative returns. The Kurtosis and Jarque- Berta statistics show that the yields are not normally distributed (see table 3).

Table 3

Descriptive Statistics of Stocks Indices

Statistics	S&P Euro 75 (EUR)	S&P EUROPE 35((EUR)	S&P Global Property (US)	DJIM
Mean	0.000267	0.000207	0.000102	0.000173
Std. Dev.	0.014352	0.012527	0.011736	0.014165
Skewness	- 0.081474	- 0.096070	- 0.401385	0.021635
Kurtosis	9.453163	10.98897	11.38589	12.56949

Table 4

Yields Correlation with Diversification Benefits

Jarque-Bera	4371.863	6700.037	7445.676	9607.957
Probability	0.00000	0.00000	0.000000	0.000000

Note: Std. Dev. stands for Standard deviation.

Table 4 indicates that yields are highly correlated which means that there are no diversification benefits.

Table 5

Simple Correlations analysis

Probability	S&P Euro 75 (EUR)	S&P EUROPE 350 (EUR)	S&P Global Property (US)	DJIM
S&P Euro 75	1.000000			
S&P EUROPE 350	0.959652 (0.0000)	1.000000		
S&P Global Property	0.626939 (0.0000)	0.641085 (0.0000)	1.000000	
DJIM	0.859494 (0.0000)	0.881541 (0.0000)	0.658666 (0.0000)	1.000000

Notes: Numbers in brackets are p-values.

The correlation degree is a good preliminary proxy to forecast any contagion effect related to the economic and financial crisis. From 70's to 90's, some studies demonstrate that there is a low correlation between stock indices (Solnik, 1991); Lee and Kim, 1993; Arshanapalli and Doukas, 1993; Masih, 1997; Merci 1997; Masih, 2001; and Longin and Solnik. 2001). Recent analysis on the topic show that the indices are highly correlated (Yang *et al.*, 2003; Narayan, 2004; Bley and Chen, 2006; Chuang and Tswei, 2007; Chapra, 2008; Alkulaib *et al.*, 2009; Chang *et al.*, 2010; Pop and Darne, 2011; and Walid *et al*., 2011). The financial liberalization and the finTech activities developments tend to reinforce this phenomenon (Kearney and Lucey, 2004).

To develop the linkage between indices, we perform a causality test (Granger) and we report only the relevant results[6].

Table 6

Pair wise Granger Causality Tests (sample: 7/31/2007-8/28/2017)

Null Hypothesis:	F-Statistic	P-values
S&P EUROPE 350 does not Granger Cause S&P Euro 75	0.39198	0.8545
S&P Euro 75 does not Granger S&P EUROPE 350	0.27405	0.9274
DJIM does not Granger Cause S&P Euro 75	0.35570	0.8787
S&P Euro 75 does not Granger Cause DJIM	0.77228	0.5698
DJIM does not Granger Cause S&P EUROPE350	0.68708	0.6333
S&P EUROPE 350 does not Granger Cause DJIM	1.16112	0.3264

For the DCC-Garch model, we do not introduce the S&P Global Property index since the causality tests results are not conclusive.

The next section presents the methodology. The main results are presented in this section.

4. Model

This section is devoted to describe shortly multivariable Garch modeling (Engle, 1982), famous for their simplicity and explicability.

The main goal of the section is to present the most general architecture of a DCC-Garch model and the results of estimations. Generally named Hadamard model, it based on specific multi-dimensional conditionally heteroscedastic properties

[6] The exhaustive results can be provided on request.

discrete-time process.

The first works on autoregressive conditional heteroscedasticity (ARCH) by Engle (1982) and Bollerslev (1986) deal with univariate volatility models, with some extensions aiming at greater flexibility (Nelson, 1991; Glosten, Jagannathan and Runkle, 1993; and Baillie, Bollerslev, and Mikkelsen, 1996).

Later, some improvements appear and provide several models associated with the multivariate approach. Often called multivariate Garch models and noted MGARCH. Amongst them we can cite : VECH of Bollerslev, Engle and Wooldridge (1988); DVECH and extensions by Bollerslev's (1990); CCCMGARCH, Engle and Kroner's (1995); Baba- Engle-Kraft-Kroner (BEKK)-GARCH, Engle's (2002); dynamic conditional correlation DCC-Garch approach, conditional variance and covariance are related to past conditional variances and past squared innovation, past squared innovation and conditional variances of other assets (Bollerslev *et al.*,1994).

Let's assume that X_t is a *v*-dimensional conditionally heteroscedastic properties discrete-time process:

$$X_t = M_t^{1/2}\varepsilon_t \qquad (1)$$

$$\varepsilon_t \xrightarrow[L]{} IN(0_n, I_n), t = 1,2,....,T$$

With ε_t a $m \times 1$vector of normally distributed such that $E(\varepsilon_t) = 0$ and $E(\varepsilon_t, \varepsilon_t^T) = I$ at time *t*

$M_t^{1/2}$ a $m \times m$matrix of conditional variances obtained by a Cholesky factorization at time *t*

$$M_t = D_t C_t D_t \qquad (2)$$

D_t is the $m \times m$ diagonal matrix of standard deviations obtained from univariate GARCH model at time t. X_t is uncorrelated in time, but there is a non-linear dependence.

$$R_t = \mu_t + X_t \qquad (3)$$

R_t is a $m \times m$ conditional correlation matrix of X_t at time t. μ_t is assumed to be constant or time series model.

For a DCC-Garch model, we have the following relations:

$$C_t = Q_t^{*-1} Q_t Q_t^{*-1} \quad (4)$$

$$Q_t = (1-a-b)\bar{Q} + a\varepsilon_{t-1}\varepsilon_{t-1}^T + bQ_{t-1} \quad (5)$$

$$\bar{Q} = \sum_1^T \frac{\varepsilon_t \varepsilon_t^T}{T}$$

$$Q_t^* = \begin{bmatrix} \sqrt{q_{11t}} & 0 & 0 \\ 0 & \sqrt{q_{22t}} & \\ & & \\ 0 & & \sqrt{q_{nnt}} \end{bmatrix}$$

Q_t is supposed to be positive. Moreover, we assume $a \geq 0, b \geq 0$ and $a + b = 1$.

Note that the different specifications of MGARCH models can be divided into several categories but for this short paper we put the emphasis on conditional variances and correlations models. Also, we will not describe this class of models since the empirical literature is flourishing and rich[7].

For this paper, we consider two different distributions for the standardized error ε_t; the multivariate Gaussian, and the multivariate Student's *t*-distribution.

When the standardized errors (ε_t) are gaussian, the joint distribution is given by:

$$f(\varepsilon_t) = \prod_1^T \frac{1}{(2\pi)^{n/2}} e^{-\frac{1}{2}\varepsilon_t{}^T \varepsilon_t} \quad (6)$$

If the standardized errors (ε_t) are Student's t-distributed, the following equation is selected:

$$f\left({}^{\varepsilon_t}/_{v}\right) = \prod_1^T \frac{\Gamma\left(\frac{v+n}{2}\right)}{\Gamma\left(\frac{v}{2}\right)[\pi(v-2)]^{1/2}} \left[1 + \frac{\varepsilon_t{}^T \varepsilon_t}{v-2}\right]^{-\frac{n+v}{2}} \quad (7)$$

As all estimations are based on Garch processes, the choice of start values is extremely important which conditioned the results. Moreover, if the number of parameters to estimate is too large, the likelihood function becomes flat and often the model tends to local optima. To avoid this problem we run the estimation with different starting values. The starting values chosen are the combination of values that yield the

[7] For more details see Engle, R. F., & Kroner, K. (1995), Engle, R. (2002), Pesaran, B., & Pesaran, M. H. (2007).

highest likelihood. Another problem of convergence may arise in the case of outliers. One of the solutions is to remove the outliers.

The goal of the next section is to expose and to discuss the empirical results of different DCC-Garch models outcomes based on Gauss and t distributions.

5. Results

We run a DCC-Garch model associated with Gaussian and t-densities. As already underlined above, we will take into account only three variables: DJIM, S&P 350 and S&P 75. DCC-Garch model results are summarized in table 7.

Table 7

Estimations results of the DCC-Garch model (*Gaussian distribution vs t-distribution*)

Parameters	Gaussian density Estimate(Maximum-Likelihood/ BFGS[8])	t-density Estimate(Maximum-Likelihood/ BFGS)
$\lambda 11$	0.91650***	0.92125***
	(0.01663)	(0.015084)
$\lambda 12$	0.91999***	0.93159***
	(0.015989)	(0.013450)
$\lambda 13$	0.90459***	0.91989***
	(0.02230)	(0.011949)
$\lambda 21$	0.06450***	0.05969***
	(0.013743)	(0.01779)
$\lambda 22$	0.06769***	0.06199***
	(0.014117)	(0.014117)
$\lambda 23$	0.06376***	0.05874***
	(0.02230)	(0.01959)
$\delta 1$	0.93560	0.94165
$\delta 2$	0.03699	0.03459
υ		8.5924
Maximum Log-likelihood	-9 769.90	-9 621.90
AIC	17.928	17.465
SBC	18.024	17.834

[8] Broyden-Fletcher-Goldfarb-Shannon. We use R package Bayes Dcc Garch for DCC-Garch model estimations coverage.

Notes: The results are based on a DCC-Garch model with gaussian and t-student densities for the period 2007-2017. The i=1,2,3 is respectively DJIM, S&P 350 and S&P 75. Numbers in brackets are standard errors. Test critical values at 1%, 5% and 10% are respectively ***,**, and *. υ is the degree of freedom. λ coefficients are volatility parameters.

From table 7 we notice that all coefficients are highly significant for the parameters (λ_{ij}) for i=1,2 and j=1,2,3.The estimated coefficients (λ_{1j}) are close to one, there is a gradual volatility decay for both models. We observe that the sums of $(\lambda_{1j}, \lambda_{2,j})$ are less than one for each index suggesting that volatility shocks are transitory and not permanent. It is a usual outcome for high volatility variables (Saiti et al. (2014) as $\sum_{1}^{2}\delta_i < 1$, the models converge.

Moreover, the maximum log-likelihood is greater for the t-density model than the Gaussian model. The model with the lowest AIC and SBC is preferred. Given the AIC and SBC criteria, the Gaussian model underperforms the t-model (Pesaran, 2007; and Saidi *et al.*, 2014). Therefore, we conclude that the DCC-Garch model associated with a t-distribution is more appropriate to model fat tailed variables. This is in line with the elementary statistics reported in table 3. The degree of freedom is far below the threshold limit (30).

We observe that there is a strong relationship between Islamic market and conventional European market (0.93). This is not surprising since the most recent empirical literature provides the same conclusion (Rua and Nunes, 2009; Saiti *et al.*, 2014; and Bala and Taimoto, 2017). Hence, our findings reinforce the idea of the contagion effect possibility between Islamic finance and traditional finance. Indeed, the financial crisis has affected US market; EU market and Islamic market (see chart 1 and breakdown tests table 2). Despite the Islamic finance stability we cannot reject the hypothesis of imported crisis. Nevertheless, we observe that according to the skewness statistics, Islamic index outperforms US indices.

Islamic finance may be a good alternative to conventional finance especially during financial crisis thanks to its healthy management. As already underlined in section 1, Islamic finance is based on a sharing of profits & losses and some interdictions (speculation and usury) but given the interaction between markets, a contagion effect related to European or US crisis cannot be excluded. Nevertheless, we assess that the 2011 crisis did not impact Islamic finance. This assessment may be related to the crisis severity (Rizvi and Arshad, 2013). It may be interesting to develop models based on various degrees of crisis and measure the impact of imported economic turbulences.

Globally, the challenge for the Islamic finance is to find solutions to contain systemic risks linked to interdependent markets.

6. Conclusion

We have examined the stock market volatility contagion for different financial indices after the last financial crisis. We have taken into account an Islamic index, largely used by the empirical literature and different European indices namely Dow Jones Islamic Market Index (DJIM), S&P Global Property US, S&P Euro 75 (EUR) and, S&P EUROPE 350 (EUR). For each variable, we have provided some statistical analysis in order to run a DCC-Garch model. For the DCC-Garch model, we have use two densities: Gaussian and t-densities. The pre-tests led us to withdraw the real estate variable since the causality estimation is not conclusive. Both densities approaches provide significant and relevant results. But, if we compare the two models, the best model is one that takes into account t-densities. This conclusion is based on three criteria, the log-likelihood, the Akaike (AIC) and Schwartz Bayesian criteria (SBC).

The main results obtained for period (2007-2017) show that the financial indices are highly correlated. This result is not surprising due to financial integration and commercial globalization (Saiti, 2013; and Saiti *et al.*, 2014). Nevertheless, in case of financial crisis, the contagion risk is not excluded and this assessment should be integrated into any stabilization policies (Hwahsin *et al.*, 2006). Nowadays, the Islamic index cannot be perceived as an alternative asset but a supplementary asset. Indeed, the Islamic index yields are impacted by worldwide financial events. The financial crises are often imported. Nevertheless, we regret that we did not have a database before 2007 because of its availability. We cannot, therefore, develop models with long-term memories. 2/ A DCC- Garch model associated with a t-distribution are more performant than a model associated with a Gaussian distribution.

Despite the interesting results shown in the study some limitations have also been identified. For example, the size of the sample is relatively short (from 2007 to 2017). Similarly we have selected only 4 indices, more indices will improve the robustness of the model. We also did not introduce the skew-t distribution while this distribution is more adapted to financial assets returns (Bala and Takimoto, 2017). The next step is to increase the quality of the estimations according to the limits.

Nevertheless, the main results deduced from the estimation models are crucial for policy makers in the implementation of financial stabilization policies. The financial crises are not without implications for other markets due to the financial globalization (Arshanapalli and Doukas, 1993; Kearney, 1996; Charles *et al.*, 2011; Cheng *et al.*, 2008; Alkulaib *et al.*, 2009; and Francis *et al.*, 2008). Nowadays, it is inconceivable to present financial indices models without a linkage framework.

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The ASEAN Market: Cross-Border Collaboration in Islamic Finance between Malaysia and Thailand

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Abstract

Islamic finance offers a viable and moral-ethical alternative when the world economy suffers from global financial crises due to high debt-gearing and excessive speculations leading to liquidations and losses. In the casino-like scenario of the conventional order, Islamic finance is viewed as a game-changer, setting new rules and behavioral patterns that appeal to humanity and other civilizations due to its adherence to the universal principles of justice, equity and good conscience. In the beginning, Islamic finance may have started off with a nationalistic or religious fervor due to independence from colonialism and reassertion of an Islamic identity. But it has become evident to the world that its core principles, if implemented sincerely, can prevent exploitation, monopoly, bribery and corruption, excessive spending and hoarding of wealth, high debt- gearing and speculation. Ideally, Islamic finance should be promoting values such as entrepreneurship, transparent dealings, risk sharing, profit and loss sharing rather than making profits from a predetermined return. Islamic finance is also based on ethical principles such as trustworthiness and honest dealings, sanctity of contracts, moderate and pragmatic behavior and equitable treatment of stakeholders. This paper examines the role of Islamic finance in developing the ASEAN financial market through cross- border collaboration, specifically with Thailand, through three engines of growth: the Sukuk market, Halal market and Waqf. Islamic finance has opened up many opportunities to the minority Muslims in Thailand and has helped speeded up the integration process. As the world becomes smaller and cross-border players increase, there is a need to have greater legal and regulatory certainty. To ensure Islamic finance is on a level playing field with conventional finance as it crosses borders, the present authors recommend a mutual relaxation of taxation laws and a trade liberalization policy. Lastly, a unified and concerted effort is needed to promote equitable development of ASEAN member nations within the Islamic framework of "prospering thy neighbors".

Keywords: Cross-border trade, ASEAN, Islamic finance, global financial crises, Islamic worldview.

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Introduction

Malaysia took the lead in influencing the growth of Islamic finance in South East Asia since the 1980s and is now the model for all ASEAN and other regions to follow. In relation to cross border collaborations, there are divine principles in Islamic finance which can be incorporated under the ASEAN umbrella. These are mutual cooperation and brotherhood (*ukhuwah*) and where trade relations should be based on the spirit of "prospering thy neighbors". In Islam, we are required to look after the rights of the neighbor through mutual cooperation and solidarity in a spirit of brotherhood.

It is exhorted in the Qur'an that to care for the rights of the neighbor is one of the essentials of the Faith, and it is forbidden to harm him or ignore his rights, as God says: "*Ascribe no thing as partner unto Him. (Show) kindness unto parents, and unto near kindred, and orphans, and the needy, unto the neighbor who is of kin (unto you) and the neighbor who is not of kin*…" And to this I will include our non-Muslim neighbors who form the human race with Muslims. The Holy Prophet (pbuh) said: "*Whoso has faith in Allah and in the Hereafter, should honor his neighbor"* (Bukhari and Muslim). And if you behave nicely to your neighbor, you would become a true Muslim.

However, these principles are in direct conflict with the capitalistic principles of competition which believes in competition and not mutual cooperation and "survival of the fittest" based on greed and selfish behavior of men. This creates a gap between the two worldviews. But at the same time the Islamic worldview provides an alternative to stakeholders to choose which system is relatively more beneficial for them in terms of realization of commercial and social objectives. It is recommended in this paper that greater collaboration should come in the Islamic spirit of "prospering thy neighbors" through three markets: Sukuk, Halal industry and Awqaf.

Investors and industry players in the regional and global market who participate in cross-border trading require legal and regulatory certainty to protect their overseas investments. Laws need to be mutually relaxed and liberalized for a meaningful collaboration. A unified and concerted approach by cross-border trading partners should not only fulfill commercial but also social goals such as alleviation of poverty and economic empowerment of ASEAN member nations. By infusing Islamic principles in existing conventional systems, Islamic finance is offering an alternative framework that will appeal to humanity due to the universal principles of justice, equity and good conscience and mutual cooperation in the spirit of prospering thy neighbor's.

Islamic finance is also known for its core principles which are to prevent exploitation, monopoly, bribery and corruption, excessive spending and hoarding of wealth whilst promoting values such as entrepreneurship, transparent dealings, fair distribution of risks, and profit and loss sharing principles. The Islamic world view and foundational philosophy of Islamic finance provide the basis for honest dealings, sanctity of contracts, moderate and pragmatic behavior, and equitable treatment of stakeholders which lead to social justice. If ASEAN were to achieve the 'One Vision, One Identity and One Community' goal, then it must ensure that Islamic finance, when adopted in the emerging economies, is on a level playing field with conventional finance as it crosses border.

2. The Foundational Philosophy of Islamic Finance as an Islamic Alternative to Conventional Financial Markets

Islamic finance consists of four principal markets: Islamic banking, Islamic insurance (Takaful), Islamic capital market and Islamic wealth management. To this we may add Islamic Endowment or Awqaf, which has been said to be the missing piece in Islamic finance. All the above components/markets are underpinned by Islamic principles or the Shari'ah. The word Shari'ah literally means "the way to a watering place". It is the path not only leading to Allah, but also believed by all Muslims to be the path shown by Allah the Creator, through his Messenger the Prophet Mohammed (PBUH). In Islam, Allah alone is sovereign and it is He who has the right to ordain a path for the guidance of mankind. Thus it is only Shari'ah that liberates man from servitude to anyone other than Allah. This is the central reason why Muslims are obliged to strive for the implementation of that path and no other.

Al-Tawhid (or the unity of God) is thus the key element in the conceptualization and definition of Islamic worldview. Naquib Al-Attas (2008) defines Islamic worldview as "the vision of reality and truth that appears before our mind's eye revealing what existence is all about; for it is the world of existence in its totality that Islam is projecting…which includes the "seen" and "unseen" worlds. It is not a world view that is formed merely by the coming together of various cultural objects, values and phenomena into an artificial coherence; it is not one that is formed gradually through a historical process of philosophical speculation and scientific discovery; it is not a worldview that undergoes a dialectical process of transformation repeated through the ages, from thesis to anti-thesis then synthesis". The oneness of God is revealed in the Quran:

"*Say He is Allah, the One, Allah-us-Samad (the self-sufficient Master, whom all creatures need, He neither eats nor drinks). He begets not, nor was He begotten; And there is none co-equal or comparable unto him"* (Quran: 112)

Thus to be a Muslim is to believe in the Oneness of God and to have God constantly present in one's life. In the Shari'ah there is an explicit emphasis on the fact that Allah is the Lawgiver, and the whole Ummah, the nation of Islam, is merely His trustee. It is because of this principle that the Ummah enjoys a derivative rule-making power and not an absolute law-creating prerogative.

The Islamic State consists of one vast "homogenous" commonwealth of people who have a common goal and a common destiny and who are guided by a common ideology in all matters both temporal and spiritual. The entire Muslim ummah lives under the Shari‘ah to which every member has to submit, with sovereignty belonging to Allah alone. The laws of Islam are firmly based upon the Shari‘ah and are therefore deemed to be in the interest of the people as a whole.

The difference between other legal systems and the Shari‘ah is that the fountainhead of the Shari‘ah is Qur’an and the Sunnah. The Quran and the Sunnah are the gifts given to the entire Ummah. Therefore the Ummah as a whole is collectively responsible for the administration of justice. And under the Shari‘ah, justice is administered in the name of Allah and not by human definitions of justice.

The Islamic Worldview thus moulds the foundational philosophy of Islamic finance. It is centered on “*Tawhidic* paradigm”, that is, belief in the oneness of Allah and that human beings are subject to His judgment in the Hereafter. The Islamic worldview thus offers a universal worldview as well as provides rational and scientific evidences for its claims. The underlying principle of shariah law relevant to Islamic finance as sourced from the Quran (the sacred book that records the word of God as revealed to the Prophet Mohamed) is that interest (*riba’*) is prohibited: “*God has permitted trade and forbidden interest* (Quran: 2:275). The second source is the Hadith: the body of documents that records the *sunnah*, the practice or life example of the Prophet Mohammed. From these two sources there are five main prohibitions that must be observed in the creation of a shari‘ah-compliant financial services model and other principles which are mutually supportive towards a just economic system envisioned by Islam:

a. *Riba’*: the payment and receipt of interest are prohibited and any obligation to pay interest is considered void.

b. *Gharar* or uncertainty is forbidden as there must be a full and fair disclosure. For instance there must be certainty in the fundamental terms of the contract such as the subject-matter, price and time for delivery.

c. *Maysir*: the prohibition of speculation or gambling which is based on zero- sum game, where no effort is exerted to become rich, or gaining something by chance rather than productive effort.

d. *Unjust enrichment* contracts where one party gains unjustly at the expense of another are considered void.

e. *Unethical or haram investment*: Islam prohibits investing or dealing in certain products such as alcohol, armaments, and pork, and in activities such as gambling, entertainment and hotels.

f. *Debt-trading is prohibited*: Islamic finance encourages productive trading. Trading in debt is perceived as another form of *riba’*.

g. *Underlying assets*: Islamic finance is based on underlying asset transaction which contributes towards real economy. Tangible underlying assets/enterprise forms the basis of most Islamic Finance transactions.

h. *Sellers must own assets* prior to sales: Sharing of risks & rewards, elimination short selling, future sales (only in exceptional situations) via Salam or Istisna contracts.

i. *Genuine trade transactions*: Strong link between finance and actual economic activities whereby finance must be supported by economically productive activities and excessive debt leveraging is prohibited

j. *Profit and loss sharing (PLS)* principles: the Islamic financier should only generate benefit from the project in which they invest and must take some risk, since risk equates to effort and potential loss.

k. *Entrepreneurship* is encouraged in Islam.

l. In Islam *money is not a commodity* but a medium of exchange and so it is not allowed to make money on money, but it is permissible to make money on the use or the exchange of an asset.

m. Islam allows the *use of securities* to support a transaction, which guards against the willful wrongdoing or carelessness of partners.

n. *Higher level of disclosures*: Further need of transparency to provide comfort about Shariah-compliance and also other risks which are unique to Islamic Finance

o. *Currency Speculation*: Trading in currencies is prohibited due to its speculative nature.

To ensure IFIs adherence or compliance to these underlying principles, there must be a board of Shari‘ah scholars and/or experts in Islamic finance and law established within the organization to monitor and supervise Shari‘ah compliance through a Shari‘ah governance framework. It is hoped that this community or neighbor lines spirit is within the Vision-Mission-Goal (VMG) of ASEAN.

3. Malaysia and Thailand as Cross-Border Partners in ASEAN

The Association of Southeast Asian Nations (ASEAN) is a political and economic organization of ten (10) Southeast Asian countries, which was formed on 8 August 1967 by Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Since then, membership has expanded to include Brunei, Cambodia, Laos, Myanmar and Vietnam. Its aims include accelerating economic growth, social progress, and socio-cultural evolution among its members, protection of regional peace and stability, and opportunities for member countries to discuss differences peacefully. When emerging economies like Vietnam, Laos, Myanmar, and Cambodia joined ASEAN in the late

1990s, concerns were raised on the developmental divide between older and newer members with reference to the gap in average per capita GDP. In response, the 'Initiative for ASEAN Integration (IAI') was formed by ASEAN for regional integration with the principal goal of bridging this developmental divide, which, in addition to disparities in per capita GDP, is manifested by disparities in dimensions of human development such as life expectancy and literacy rates.

It is recommended here that greater cooperation should be harnessed amongst ASEAN member nations in the area of Islamic Capital Market (especially the Sukuk market), Halal industry and Islamic endowment (waqf), as these sectors represent engines of growth. Through a. concerted effort to alleviate poverty, it can economically empower the ASEAN community and the Muslim Ummah, whilst ensuring equitable distribution of wealth within member nations and among member nations. Through this "unifying factor" trading nations in the ASEAN community can achieve the following goals:

- Socio-Economic Development
- Regional Peace and Stability
- Opportunities to discuss differences peacefully due to "common interests"

Under *maqasid al-Shari'ah*, in which the objectives of Shari'ah are focused on human welfare and protection of essential needs revolving around faith, life, intellect, family and wealth, the *maqasid* of wealth requires that wealth must be circulated in the hands of as many people as possible. The wealth created through sukuk, halal markets and waqf developments can fund infrastructural developments within the state and across borders, to help bridge the gap between developed and newly emerging economies. All trading nations depend on local and foreign investments for them to grow or expand. Investing in sukuk, the halal industry and corporate waqf will provide the unifying factor, promoting unity among ASEAN nations based on trade that eliminates interest from their financial systems [*God has permitted trade and forbidden interest* (Quran:2:275].

4. Growth Trends of Islamic Finance in the ASEAN Market

The Islamic financial market started much earlier in Malaysia with the establishment of the Pilgrim's Fund Board (Lembaga Tabung Haji) in 1969. This was an idea hatched by the former prime minister of Malaysia (Tunku Abdul Rahman) who wanted to have a systematic mobilization of funds that could assist the Muslim community to perform pilgrimage as well as participating in investments and other economic activities. This initiative was savings-based with no intermediatory role undertaken by the Pilgrim's Fund Board. Then in 1980, triggered by a growing revival of Islamic values amongst the Muslim population and reinforced by the successful implementation of Islamic banks in the Middle East, the Bumiputra Economic Congress proposed the setting up of Islamic banks in Malaysia. In 1981 the National Steering Committee undertook a study and made recommendations for the formation and operations of an Islamic bank. In 1983, the Islamic Banking Act (IBA, 1983) was enacted and Bank Islam Malaysia Berhad was incorporated as Malaysia's first Islamic bank which was subsequently listed on the KLSE in 1992. To complement the operations of Islamic banks, Takaful companies were set up under the Takaful Act, 1984. In 1999 Bank Muamalat Malaysia Berhad was incorporated to be the second full-fledged Islamic bank, as a result of a merger between Bank Bumiputera Malaysia Berhad (BBMB) and Bank of Commerce Berhad (BOCB).Under the Central Bank of Malaysia Act (2009), the dual banking system of Malaysia was given legal recognition (Section 27 of CBA 2009) where Islamic banks and conventional banks were allowed to co-exist, running parallel with one another and to give parity to the regulatory developments in both systems. With the liberalization of laws in Malaysia, conventional banks were allowed to offer Islamic banking windows and today are able to set up Islamic subsidiaries through conventional parent companies. With the introduction of the Islamic Financial Services Act 2013 (IFSA), greater oversight and tighter controls of Shari/ah compliance were put into place to deter Islamic financial institutions from violating the Shari'ah principles. A punitive section was introduced to show the seriousness of the regulators to statutorily enforce Shariah compliance through stiff measures where offenders can be fined RM25 million or 8 years imprisonment or both. The Islamic financial services industries are now given a more effective payment system with greater protection accorded to consumers and the law has expanded the avenues for greater access to justice.

In the neighboring ASEAN nations, like Thailand, Singapore, Indonesia and Brunei, the Islamic finance experiment of Malaysia was followed with the same fervor. Singapore had ambitiously declared itself to be "the regional hub for Islamic finance" at the time when Islamic finance in the Island republic was still at its infancy and lacked the critical mass for retail banking. As a consequence, the Islamic finance experiment in Singapore is said to have failed. The development of Islamic banking in Indonesia followed the Dual banking system and the vision of Malaysia by setting out their VMG in 2002 in "The Blueprint of Islamic Development in Indonesia". Thailand was convinced that Islamic banks are a viable alternative to conventional banks as they had experienced the negative effects of conventional financial philosophies and practices. The global financial crises had swept away a large number of their banks and financial institutions and affected the world economy, but they observed that the Islamic banks of Malaysia and other Islamic countries managed to stay afloat during the same crisis. This made it easy for Islamic finance to enter a Buddhist majority country and in 2002 the Islamic Bank of Thailand was set up by the Islamic Bank of Thailand Act B.E. 2545 (2002). Today there are 26 branches of the Islamic Bank of Thailand, scattered in all regions of the country in a Muslim minority country. The Tabung Amanah Islam Brunei was the first financial institution to offer savings and financing in accordance with Islamic principles when it was launched in 1991, followed two years later by the Islamic Bank of Brunei. They were joined in 2000 by the Islamic Development Bank of Brunei and today with the merger Bank Islam Brunei Darrusalam stands out as the sole Islamic bank in Brunei. Sitting on the fringes of ASEAN are countries like Kampuchea, Laos and Vietnam which do not have the necessary infrastructure to participate in Islamic finance as the ethical alternative to conventional finance.

Keeping in view the ASEAN financial market and the member nations currently participating in Islamic finance, the question is what do they have in common in terms of issues and challenges? Can Islamic finance be used as a vehicle to promote unity amongst trading nations and cross-border partners? Do ASEAN members subscribe to the philosophy of "prospering thy neighbor's" which appears to be in conformity with the ASEAN VMG? What are the common aspirations of the ASEAN members? Using the collaboration of Thailand and Malaysia as a case study, it is hoped that this paper will answer these questions. The study will highlight the areas where greater cooperation can be harnessed among member nations in the area of Islamic capital market (especially the Sukuk market), halal market and Islamic endowment (waqf) market and the legal and regulatory architecture needed to make it a reality. Wealth should be circulated in the hands of as many people as possible to ensure an equitable development among member nations.

5. Current Status of Thailand's Cross-border Collaborations with its ASEAN Neighbours

Cross-border trade is one of the key indicators of closer economic interdependence between Thailand with its neighboring countries. Cross-border trade is defined as all forms of trade or exchange of goods transacted through border checkpoints by both sides of local people or traders, who reside in provinces or communities along the border. Thailand's cross-border trade expanded rapidly due to the relaxation of border restrictions stemming from occasional political conflicts (TDRI 1997). Amongst Thailand's four bordering countries[3], Malaysia is the most advanced developing market economy. Out of the 77 provinces in Thailand, 32 provinces share a common border with four neighboring countries – a river border with Lao PDR and a land border with Cambodia, Malaysia and Myanmar.

Over the years, extensive cross-border infrastructure linkages have been developed by Thailand for its neighbors. Thailand as an emerging donor country in 2005-2009 has extended cumulative grants to Cambodia, Lao PDR and Myanmar with a total of 201.87 million USD to develop cross-border rail links, interprovincial roads and airports under the 'Neighboring Countries and Economic Development Cooperation Agency' (NEDA, 2011). Thailand participates in the GMS Information Superhighway Network (ISN) which strengthens the GMS-wide networks so as to support regional integration ((Asian Development Bank, 2007). Thailand has contributed in two other overlapping regional highway networks, notably the ASEAN

[3] The four countries are Cambodia, Lao PDR, Malaysia and Myanmar.

Highway Network signed in 1999 and the Asian Highway Network signed in 2005, which have been extended over the country along 12 routes with a total road length of 3.430km (Department of Highways of Thailand, 2011).

The cumulative cross border trade value between Thailand and neighboring countries significantly reached 170.33 billion USD with a share of 57.69% of total international trade value with neighboring countries. The cumulative share of cross border export to these neighbors was as high as 59.16%. The cumulative share of cross border import was at 40.84%, contributed by Malaysia (55.73%); Myanmar (35.92%); Lao PDR (6.89%); and Cambodia (1.44%). As a result, Thailand gained significant cumulative balance of cross border trade at 31.23 billion USD. The annual average growth of cross border trade from 1996-2001was 16.98% despite the fact that Thailand had faced severe financial crisis during 1998-2001. During enforcement of AFTA from 2002-2012, it significantly kept increasing to 24.28% per year (Table 1).Above all, when the specified AFTA tariffs became 0% in 2010, its annual cross-border trade growth considerably increased to 32.08% compared with 2009. With the increasing trend of international trade of Thailand, the intra-ASEAN trade and cross border trade are also gradually rising though the proportion of their share is low. Cross-border trade during 2008-2012 reached a significant level sharing an average of 30.97% of intra-ASEAN trade reflecting the convergence effects of bilateral and regional trade agreements and regional trade facilitation initiatives.

During the last 17 years, the bilateral cumulative cross-border trade value between Thailand and Malaysia was 97.94 billion USD. The aggregate bilateral cross border trade value expanded from 0.82 billion USD in 1996 to 16.60 billion USD in 2012, which represents 56.6% of the aggregate cross border trade value with four neighbouring countries (fig 5). As a result, Thailand gained favourable cumulative balance of cross border trade of 20.37 billion USD. The aggregate cross-border trade export sharply escalated from 0.54 billion USD in 1996 to 9.75 billion USD in 2012. For almost two decades, the annual average growth of cross border exports has been 22%. In 2012, Padang Besar border checkpoint was the key export platform facilitating a high share of 50.18%, followed by Sado border checkpoint (47.6%); Betong (1.73%) and Sungai Golok (0.33%). The rest was contributed by four other checkpoints. The major exported goods through Sadao border checkpoint were natural rubber, parts and accessories of machinery, electrical parts, processed parawood, particle board, rubber hand gloves and print circuit board. For almost two decades, the annual average growth of cross border imports has been 22%. Sadao border checkpoint dominated with 77.88% share, followed by Padang Besar border checkpoint (20.04%), and Sungai Golok border checkpoint (1.13%) and the rest was shared by four other border checkpoints. The major imported goods through Sadao border checkpoint were electrical parts, parts and accessories of machinery, auto processors, plastic products, synthetic rubber and chemical fertilizers.

6. Thailand's Cross-Border Collaboration with Malaysia on Sukuk Issuances

Malaysia and the GCC are reputed as the two traditional sukuk powerhouses. In fact Malaysia is home to 69% of the total number of sukuk issued from 1996 to third quarter of 2013; this adds up to 2,438 (over $325 billion) international and domestic Islamic papers issued. GCC total issuance accounts for 12.7% of global aggregate sukuk with 451 sukuk issued (over $123 billion). In the last three to five years new entrants such as Pakistan, Indonesia and Turkey have slowly made their presence felt in the global sukuk market. There are many other countries that are not regular sukuk issuers; there have been a handful of corporate sukuk issuances out of the UK, France and Germany, for example, and on October 29, 2013 the UK government announced plans for a debut £200 million sovereign sukuk targeted for 2014 issue.

There are several reasons for investors shifting towards the sukuk market - sukuk is said to be a relatively safer investment than buying stocks or shares or even investing in the real estate. Besides this, sukuk as an asset-class, is based on Islamic securitization principles or asset-backed securitization.[4] Most governments now depend on structuring of sukuk to raise funds for infrastructural developments. Corporations use this avenue or asset class to finance expansion programs. The quality of the assets in the asset-backed securitization is also important to sukuk holders as they are entitled to realizable proceeds upon maturity or redemption upon default. As a whole, most investors prefer asset-backed sukuk, which is secured and gives investors recourse to both asset and obligor guarantee. Asset-based sukuk gives recourse to only the obligor's credit quality. Project-based sukuk gives investor recourse only to the asset and is least preferred by investors. Conventional bonds on the other hand are debt-based securitization where the returns are predetermined and interest-based. Sukuk however adds to the real economy in the form of infrastructural developments etc. and the revenues should be based on the performance or quality of the sukuk assets and not on creditworthiness of the obligor or originator. By pooling assets, it spreads the risks based on the law of large numbers.

7. The Securitization Process

What is required in the structuring of sukuk and conventional bond is Special Purpose Vehicle (SPV), which is a trust company established to become an intermediary or broker between the seeker of funds (the originating company) and provider of funds (sukuk investor). It also acts as a trustee for sukuk holders. The SPV will issue sukuk (investment certificates) for investors to take up. The sukuk project has a long

[4] Companies make use of idle assets that are lying on their balance sheet to transform them into securities (liquid assets). This could be the case where the company is strapped by Basel 2 requirements which does not allow debt-equity ratio to exceed 30%. As the company which is poised for growth is prevented from taking a loan from the bank, it seeks funds by converting illiquid assets to liquid assets (securities) or securitization.

investment period (3–5 years). There will be income streams accruing to the sukuk holders as profits. And upon maturity, sukuk assets will be sold back to the originating company for sukuk holders to realize the capital or funds used by the originating company.

To illustrate the securitization process of sukuk, the authors have used the example of a sukuk issued by the Government of Luxembourg. In 2014, three government properties – two towers of the Gate of Europe in Kirchberg and the Gutenberg building in Strassen were sold to a Luxembourg SPV in which the Luxembourg Government was the single shareholder. The SPV was securitized by means of the sukuk holders investing €200 million who whilst receiving this value back at maturity (when the Government buys back the properties from the SPV), would receive a benchmark-linked profit rate of 0.436% to be generated from the rental income received by the SPV from the tenants of the three properties securitized. This asset linked profit generation means investors get to understand the underlying asset and are more involved in the project. All money raised has to be accounted for as it is used by the SPV to purchase the properties and the funds cannot go missing or be wasted.

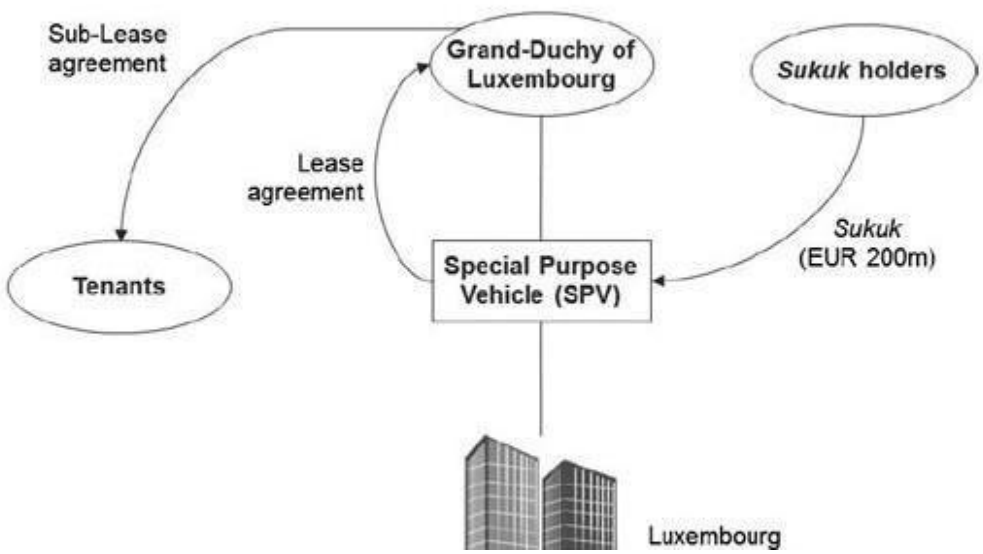

Figure 1. Sukuk issued by Government of Luxembourg

8. Sukuk Issuances in Thailand through Trans Thai-Malaysia Thailand (TTMT) Sukuk Berhad

The purpose of Malaysia's structuring of the cross-border sukuk with Thailand is to raise funds for a joint-gas project in Southern Thailand. It is planned to bridge the gap between the prosperous and poorer parts of Thailand and to appease the unrest in the Muslim majority regions who have been clamoring for secession from main Thailand due to unequal economic development in the various regions of Thailand.

TTMT is a 50:50 joint venture between project sponsors Petroliam Nasional Bhd (Petronas) and PTT Public Company Ltd (PTT). The cross-border sukuk, TTM Sukuk Bhd is a wholly-owned subsidiary of Trans Thai-Malaysia Thailand and the issuer (SPV or funding vehicle) of TTMT to build two more gas pipelines to transport natural gas from the Malaysia-Thailand Joint Development Area (JDA) in the Gulf of Thailand to the industrial city of Rayong in Thailand. The gas pipeline construction, which was completed in June 2010, is the second phase of the TTM project comprising a 667km gas transmission pipeline system and a gas separation plant to meet the energy requirements in both countries. The sukuk size is RM600 million. The arrangers for this sukuk are CIMB Islamic and HSBC Amanah. Legal counsels for the issuers and lead managers consist of law firms from Malaysia, Thailand and UK for the Malaysian law, Thai Law and English law respectively. The cross border sukuk is structured and issued asa MR600 million secured Commodity Murabahah Sukuk, where the underlying assets of TTM Sukuk (the commodities) are based in Malaysia to overcome taxes such as withholding tax, VAT, stamp duty and others (Sheila, n.d).

The TTM Sukuk transaction reflects a number of important contributions.

- Firstly, this was the first Kingdom of Thailand government-linked company (GLC) issuance. This raised hopes that the Kingdom would issue directly in 2011, or that they will launch domestic Sukuk transactions, if not both.
- Secondly, it remains the demonstration of a commitment to regional peace and economic development as the issuance is made via Malaysia for a joint gas project serving southern Thailand.
- Thirdly, it is used as a case study here to show the ingenious structuring of a Shariah compliant sukuk designed to overcome transnational taxation issues.

Based on the present authors' analysis of this cross border sukuk, it can be deduced that when contracting nations have a robust and comprehensive taxation framework complemented by bilateral tax treaties to remove double taxation or any cross border tax impediments, the combined effects lead to an overall increase in cross-border flows of Islamic funds needed for infra structural developments of emerging markets.

9. Issues and Challenges to Cross-Border Sukuk

One must also be aware of the issues and challenges to cross-border Sukuk. From the perspective of the global sukuk investor, there are two main issues which are impeding demand for international sukuk. Firstly, there is the issue of enforceability from a common law and shari‘ah perspective. The second issue relates to the underlying assets that make sukuk unique. The distinction between shari‘ah-incorporated jurisdictions and purely secular jurisdictions is important in addressing the issue of when and under what circumstances shari‘ah is an enforceable element of a contract under the laws of a specific nation. It is not known what the governing laws for this TTMT sukuk are but it can be presumed that the laws of Malaysia will be the governing law of the sukuk given that Malaysia’s legal and regulatory framework is relatively more developed to protect sukuk investors. The Securities Commission of Malaysia has also issued comprehensive guidelines governing sukuk issuances to safeguard stakeholders’ interest.

One of the most important factors that are necessary for sukuk when it comes to tax regulations is to ensure that there is parity between taxation on sukuk and conventional bonds. If the tax system favors one of them, this creates an unfair market where it is impossible for the disadvantaged financial instrument to thrive. Currently, most tax systems around the world are structured to handle conventional bonds but lack some of the specific attributes necessary to work with sukuk and other Islamic financial instruments. Ownership of assets in many regions requires additional tax duties and often involves other legal transactions that incur additional costs. Without special provisions for sukuk, this characteristic of Islamic financial instruments puts them at a severe disadvantage if the right legal frameworks do not exist. A typical example is an *Ijarah* sukuk structure. In these cases, the initial transfer of asset ownership can trigger capital gains, sales tax, holding tax and stamp duty. Each time a transfer of ownership occurs, which will happen at least twice, these taxes will be required unlike conventional bonds which will only be taxed according to their capital gains. Under the Thai’s taxation framework, returns from sukuk investment are classified as “rental revenues” and are subject to property taxes. The tax code also treats transfers of land or property assets as “land transactions” and is taxable. The Thai tax code is seen here to be an impediment to the development of Islamic finance in Thailand. Latest update gathered on Thailand’s tax initiatives is that reforms are underway to remove remaining tax implications on sukuk. The proposed regulations have also set out the key requirements for Thai sukuk issuance and their disclosure requirements as well as the guidelines to achieve tax neutrality between sukuk and conventional debt securities.

Another hurdle when creating the necessary legal framework for sukuk in a country's legislation is the differential treatment between profit and interest. Most of the time interest payments are tax deductible. On the other hand, profit is taxable. Some types of transactions are affected by additional duties. For example, *Murabahah* sukuk must pay sales tax or *Ijarah* sukuk often suffers from additional stamp duty payments. Currently, the United Kingdom, Malaysia, Qatar, and Turkey are the four countries that have some of the best conditions when it comes to taxation systems and frameworks for Islamic financial instruments. Thailand has yet to review its tax regime to make it supportive of Islamic financial and investment instruments.

About the rating of sukuk, Malaysian Rating Corporation Bhd (MARC) has affirmed its AAAIS rating of Trans Thai-Malaysia (Thailand) Ltd (TTMT) unit's RM600mil *Sukuk Murabahah* with a stable outlook (Star Online, 9th February, 2015). The affirmed rating incorporates a very high probability of support for the Trans Thailand-Malaysia (TTM) project from creditworthy project sponsors, in particular Petronas on which MARC maintains a senior unsecured rating of AAA/Stable based on available public information. It has been reported that the rating is not constrained by Thailand's foreign currency rating notwithstanding that the sole off-taker of the second phase PTT and the project company TTMT are domiciled in Thailand and the project revenues are denominated in US dollars or the Thai baht equivalent. This assessment is based on Petronas' strong incentive to provide ringgit liquidity in the event of foreign exchange restrictions imposed by the Thai government. The rating also considers the credit linkages in the form of cross-acceleration and cross-default provisions between the Sukuk and the syndicated bank loan taken to finance the first phase of the project for which Petronas is the co-off taker.

There is a need for greater transparency of sukuk structures. In addition to the traditional benefits of sukuk, such as diversifying an investor base and. accessing investors who do not invest in interest based bonds, a less discussed value add of sukuk is its structure, particularly the *Ijara* structure which to a greater deal over conventional bonds prevents the wastage of funds through corruption and theft. Increased transparency can be used to inspire investor confidence and trust thus leading to increased foreign direct investment (FDI). For countries which face the challenges of corruption as well as those seeking to avoid the injustices of interest-based bond borrowing, sukuk present an opportunity to tap a new investor base, one that is ethical and provides the borrower more rights and prevents abusive interest charges in case of default. At a recent Islamic finance conference in Nigeria, Usman Hassan, CEO of Jaiz Bank, a Nigerian based Islamic Bank set up in 2003, urged the Nigerian government to take a closer look at sovereign sukuk issuances to fund infrastructure projects due to the Islamic principles governing sukuk structures where productive assets must be put to work in order to generate returns.

The Kingdom of Thailand has already talked extensively with Malaysia in the development of the domestic Thai Islamic finance market and during this transaction the relationship has been expanded and a new tool has been added to the Thai repertory. Instead of *Bai alInah,* the transaction follows the *Tawarruq* method and utilizes Ableace Raakin's to secure the needed funds in an Islamic sales transaction.

10. Thailand's Cross-Border Collaboration with Malaysia on Empowering the Halal Industry

The Halal food industry has great potential for further growth and enhancing cooperation amongst trading nations as halal food is now in greater demand in the global market. Thailand is a leading food producer with internationally recognized standards. In 2011, Thai halal food exports increased by 30 percent. Major markets for Thai halal food include Indonesia, Malaysia, Nigeria and other ASEAN region, with more than 60 percent of the exports going to Indonesia, Malaysia and Brunei Darussalam.

Cooperation in the halal industry has always been a major topic of discussion with its Malaysian neighbors to strengthen economic partnership. On October 30th, 2012, during a two day trade and investment mission organized by the International Trade and Industry Ministry in collaboration with the Halal Industry Development Corporation (HIDC) and East Coast Economic Region Development Council, it was announced that Malaysia and Thailand would work closely to empower the halal industry (Mustapa Mohammad, Malaysia's International Trade and Industry Minister, 2012, News Agencies). More than 90 Malaysian companies participated in the mission to work with their counterparts.

The halal food industry has great potential for further growth and enhancing cooperation among trading nations as halal food is now in greater demand in the global market.

Previously, Thai food products were little known in the Middle East. However in 2012, after signing an MOU on trade and investment cooperation in agricultural products with Bahrain and Qatar, Thailand is optimistic about the continued growth of its halal industry. Cooperation with Bahrain and Qatar in the halal food industry is expected to promote Thai halal food exports to the Middle East. With the GCC countries' support for the halal food industry in the southern border provinces of Thailand, it is expected to contribute to the development of the Thai economy and more equitable distribution of wealth.

Domestically, the Government of Thailand continues to support food production under Thailand's "Kitchen of the World" strategy. The department of industry promotion has set plans to spend 29 million baht in raising the standards of Thai Halal entrepreneurs in terms of production and marketing. With the goal to increase Thai Halal export growth to more than 8% a year, the department will help the entrepreneurs pass more standards so that their products are accepted by Muslim consumers. To this end the following organizations have been established to support its halal industry:

a. The Central Islamic Council of Thailand

b. The Halal Standard Institute of Thailand

c. The Halal Science Centre Chulalongkorn University

d. Halal Forensic Laboratory at Yala Rajabhat University

The Ministry of Industry in its effort to push for the development of the Thai Halal industry is launching a pilot project for 150 entrepreneurs with the objective to help them enter the ASEAN market. Pattani (one of the southern border provinces of Thailand) is being developed into a halal industrial center. Located in Panare district of Pattani, the Government offers special privileges for investors wishing to invest in the Halal Food Industrial Estate. It has also helped in the establishment of the Islamic Bank of Thailand. The Halal Science Center in Chulalongkorn University in Bangkok also plays an important role in developing the standards of Thai halal food. As a result of the extensive collaboration with its ASEAN neighbors and the GCC countries, greater business opportunities have been opened up for the Thai halal food industry. Thai Halal exports were worth almost three billion USD after the first half of 2014.

Back in Malaysia, an initiative is already under way with HIDC to integrate halal financing (Islamic financing) with halal industry (food, pharmaceuticals, cosmetics etc.) to further grow both industries. Hopefully, it will attract 1.9 billion Muslim consumers worldwide.

11. Thailand's Cross Border Collaboration with Malaysia on Awqaf Development

Waqf is a tool for eradicating poverty and promoting socio-economic development. The institution of waqf has been around in Islamic civilization since the time of Prophet Mohammad (PBUH). However with the fall of the Ottoman Empire, waqf institutions around the world suffered a setback due to mismanagement and diminishing Islamic values to endow property in the name of Allah for public benefit and charitable purposes for the needy, the orphans, the indigents and the widows. Besides being a tool for philanthropy, it can be explored further about how it may be used for productive purposes. This means finding ways to generate revenue from waqf assets which can be channeled for consumptive purposes like building mosques, education, healthcare, agricultural production and other services which can alleviate poverty and contribute towards the socio-economic development of a country. The type of waqf assets that can be utilized to raise funds can be in the form of movables (cash waqf) and immovables (land, etc). Movable waqf has been legitimized by the four schools of Islamic jurisprudence. The definition of waqf albeit for movable or immovable property is summed up as:

"The confinement of property or an amount of money by a founder (s), (individuals, companies, institutions, corporations or organizations), and the dedication of its usufruct in perpetuity to the welfare of the society".

Where the waqf management is undertaken by a corporation[5], it becomes a corporate waqf and is defined in the following manner:

"The confinement of an amount of liquid money, shares, profit, dividends by founder(s) such as individuals, companies, corporations, organizations or institutions, and the dedication of its usufruct in perpetuity to the welfare of society".

Where waqf is corporatized, this means that the money, profit, shares, dividends and liabilities of the business belong to the corporation, not to the shareholders. In addition to its legal personality, once the corporate waqf is registered, it will have limited liability and will be governed by a Board of Directors appointed by the founder; the BOD will appoint the *mutawalli*/trustee (specifically an associate institution) in order to manage the affairs of the corporate waqf; and the beneficiaries should be specified by the founder in his or her *hujjah*/*waqfiah* (waqf deed) (Magda, 2014).Similar to the investment of cash waqf, the accumulated funds in the associated waqf institutions or waqf foundation can be invested in any lawful investment albeit in low or high risk investment.

The objective of the Shari'ah is to ensure that economic prosperity is achieved through fair means and that wealth is generated and circulated for public benefit based on distributive justice to achieve social justice and *falah* or happiness for society. This type of financing vehicle should be explored further about how countries can use waqf (illiquid and liquid assets) to raise funds through *sukuk waqf* for infrastructural developments; and waqf-based micro-financing to provide funding for SMEs and fostering entrepreneurship, and waqf shares to finance the growth of cottage industries dominated by women or by the founder granting them a goodly loan or *qardulhasan* from the profit of waqf; or even to assist industry members who are facing financial difficulty through such interest-free loans.

Waqf properties in Thailand have been increasing since the presence of mosques in Thailand. However, the waqf is not managed in a convenient manner. According to a study, the greatest form of waqf management in Thailand is the rental form. The key problem of waqf management is the lack of understanding about it and the key obstacle is waqf administrative law (Orawit, Boonchom, 2009). There is lack of awareness on the economic significance of waqf in Thailand. However Thailand appears to be reviving the waqf spirit as on January 18, 2013 a sermon was delivered on 'Reviving the Spirit of Waqf-e- Nau' by Hadhrat Mirza Masroor Ahmad organized by Ahmadiyya Muslim Community, Thailand.

[5] A corporation is a legal business structure that establishes the business as being a separate entity from the shareholders. Once a corporation is created, it becomes an incorporated entity having a separate legal entity.

12. Conclusion and Recommendations

It is asserted here that greater cooperation should be garnered with more members of ASEAN especially in Cambodia, Laos and Myanmar, These countries represent the less developed or emerging economies of ASEAN. In order to bridge the regional gap, greater assistance should come from developed or more prosperous ASEAN members. Assistance can come in the form of developing the Islamic financial markets in those countries through financing the infrastructural developments and introducing regulations before they can participate in the Sukuk, Halal and waqf markets.

These three markets have been the "engines of economic growth" for Thailand as discussed above. These Islamic financial markets can alleviate poverty, economically empower the ASEAN community and the Muslim ummah; ensure equitable distribution of wealth and enable Muslim Ummah to fulfill the spirit of "prospering thy neighbor's" within a legally acceptable framework and political platform. Under *maqasid al- Shari'ah*, the objectives of Shari'ah is focused on human welfare and protection of essential needs such as faith, life, intellect, family and wealth. The *maqasid* of wealth requires that wealth must be circulated in the hands of as many people as possible to fund infrastructural developments within the state for public benefit and across borders to help fund newly emerging economies. All trading nations depend on local and foreign investments for them to grow or expand. Investing in sukuk, the halal industry and corporate waqf will provide the unifying factor, promoting unity among ASEAN nations as *God has permitted trade and forbidden interest* (Quran:2:275).

Given the impediments to cross-border collaborations in Islamic finance, the following recommendations are made:

12.1. Removal of Restrictions to Trade. There should be a mutual relaxation of laws to allow Islamic finance to develop with all the benefits discussed above. This includes liberalization of taxation laws, tax treaties and jurisdiction laws which are supportive of sukuk issuances, halal industry and Islamic endowment. (Contract and shariah enforceability)

12.2. Creating a Levelled Playing Field. A levelled playing field should be created for Islamicfinancetobecompetitiveandlesscostlythrougharobustlegalandregulatoryand tax framework.

12.3. Unified and Concerted Effort. A unified and concerted approach is needed to alleviate poverty and economically empower emerging ASEAN member nations through Islamic finance.

12.4. Setting up an International Waqf Bank through IDB. The idea of setting up a Waqf bank or even an international waqf bank has been bandied around at international waqf conferences. It is hoped that the pooling of waqf resources and assets will be a step towards helping to enrich ASEAN members, specifically in Cambodia, Laos, Myanmar and the Philippines.

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The Role of the Zakat System during the Colonial-period in Malaysia and Uzbekistan: A Comparative Analysis

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Abstract

During the colonial period, the zakat system in both Uzbekistan and Malaysia experienced serious changes due to imperial powers' intervention. The zakat system was an important source of economy for these states. This paper highlights the zakat practices of pre-colonial and colonial Uzbekistan and Malaysia, and clarifies the nature of encounters of different civilizations such as Islamic and Christian in these regions. The main objective of this study is to find similarities and differences in the imperialists' influence on structural level of taxation and zakat systems between the countries studied. This study reveals that there are similarities such as in the administration of zakat collection after the arrival of the imperial powers, where in both countries, the colonial powers appointed supervisors over local zakat collectors, in order to control revenues. This research also found some important differences that arose because of the intervention of the colonialists, where British helped in establishing centralized zakat collection, whereas Russians totally abolished zakat system by turning it into conventional taxation.

Keywords: Zakat, Zakat institution, colonialism, Muslim society

Introduction

Zakat, being one of the five pillars of Islam, in its inherent nature helps to balance the society. There are many verses in the Qur'an e.g., (Al An'aam: Ayat 141), (Al Baqarah: Ayat 265) (Al Anfal: Ayat 2-3), which emphasize the payment of Zakat and *Ṣadaqah*. This research compares the influence of two imperialist powers on the zakat systems of Muslim countries namely Malaysia and Uzbekistan during their reign. This work also attempts to reveal reasons of why colonists took actions toward changing old systems of tax collections as well as zakat collections. This study intends to clarify the socio-political life in the countries under focus during imperial powers' regime and to identify the similar and different characteristics of taxation and zakat systems of these

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countries during that period. Secondary sources such as colonial studies from the viewpoint of outside researchers on the Central Asia contain little information on taxation and specifically zakat management. Hence this work attempts to fill in this gap.

The British in Malaya and the Russians in Central Asia took serious steps to modernize existing laws and promulgated, as they perceived, more advanced criminal and civil laws in order to influence socio-cultural relationships in their respective states. Nevertheless, the efforts to initiate social changes did not totally change but only influenced the population, which was involved in government related jobs. However, the living of common people did not change as colonialists targeted due to strong traditions and the role of family cohesiveness in building Muslim identity in relation to religion which was the same as before the colonists' invasion. Such influence in Central Asia did not diminish the role of *Shari'ah*and traditions (*adat*), which had not been taken into account by the invaders in the beginning. The legal proceedings of both Malaya and Central Asia were in the hands of *Ulama.* "Prior to the establishment of the Religious Councils in each state of Malaysia, the village imams had administered zakat throughout the country (Hasan, 1987). Zakat was collected by the local zakat collectors (*amil*) or *aksakal*[4] in case of Uzbekistan and the Imam of the local masjid in the case of Malaysia.

Paying specific attention to structural changes in governing the state's religious authorities and taxation system in the respective countries, during the colonial time as compared to the pre-colonial era, will enable us to see the similarities as well as the differences in the aspects of zakat management and taxation in general among the countries being studied. Insight about these structural changes in governing the country will allow us to understand the situation, which specifically reflects administration of the zakat and taxation systems. Changes which reflected zakat administration were due to fragmentation of traditional political arrangement and in the case of Malaysia, centralization of real power in the hands of the British residents. For example, in Malaysia an introduction of an alien system of civil and criminal law to regulate all departments of life, other than touching upon 'Malay religion and custom', resulted understandably in the pressure to establish a 'formal' moral system of Islamic law (meaning backed by statues, acts, legislation etc. in the western sense) than hitherto existed (Muhammad, 1987). During colonial rule in Malaysia, the range of statutes and acts passed regarding various aspects of Islamic laws pertaining to marriage and divorce, inheritance and zakat management as well as the role of *Kathi* and religious courts became limited. This study focuses on the situation regarding zakat and taxation practices of right before the arrival of the colonial powers and during their rule in these

[4] 'White-beard': An elder, a village headman who played an important role at the village level and related works such as to help in solving family, tax and land disputes.

countries. In Uzbekistan, our focus remains on Bukhara emirate and Turkestan region. The Russians conquered lands of Bukhara and Kokand khanates gradually. Later, in 1868 the Russians moved towards Samarkand and conquered this important city. On May 2, 1868, Kaufman occupied Samarkand (Becker, 2004).

In Malaysia British took over gradually all states starting from Penang in 1786 and administration in Malaya began in 1874 with the Treaty of '*Pangkor'*. As a result, a British Resident was appointed to help manage the state's administration. British interference continued to expand to Selangor, Negeri Sembilan and Pahang under the pretext of maintaining order in these states, which were ultimately united under one administration of the Federal Malay States. A British Resident was appointed to administer finances and other matters with the exception of Malay customs and the Islamic religion (Hooker, 2003). Selangor, Kelantan and Kedah states played an important role in the re-organization of the zakat system in Malaya and will investigate their. Through 1909 Anglo-Siamese Treaty, British suzerainty was extended to the northern states of Kedah, Kelantan, Perlis and Terengganu and in 1914 Johore formed Unfederated Malay States (UMS). In UMS, British took control over administration rather slowly as compared to FMS, and instead of the Resident UMS states had to comply with Advisors appointed by the British (Abdulhamid, 2004).

2. Zakat System in Colonial Uzbekistan

In Central Asia zakat as a system existed since the arrival of the Islam in the 7th century. Before the Russians conquest, zakat practices were common. The Government officials, such as *Kush-begi* and subject to him were the *divan-begi* (finance minister and treasurer) and his subordinate the *zakatchi-kalan* (in Bukhara emirate) or *zakatchi* (in Kokand khanate) administered the Zakat system (Becker, 2004). In Bukhara emirate, there were two main *zakatchi*, who respectively were given areas to administer. First *zakatchi* was responsible to administer the western part of the emirate, whereas another one was responsible of the eastern part of the emirate. Both had subordinates in districts totaling in number more than 30. Other *zakatchi* specialized in the zakat collections from the livestock and had to move around to identify farmers who had cattle. The importance of the zakat collectors' location was vivid due to the trade routes which connected Russia, India and Afghanistan passed through Central Asia, and zakat on movable property was one of the most common types. Zakat collections from trade articles, livestock and land produces were among the most popular ones in Central Asia.

2.1. *Kheraj* Collection Scheme in Turkestan

Kheraj collections[5] during colonial rule were practiced in Central Asia in the same way

[5] *Kheraj* was collected 1/10 of the yield from mainly wheat and other grains. It was collected in kind, not in cash until the Russians made changes starting from 1871 in the collection methods. Russians established *kheraj* payments in cash, which was determined by the average prices of the yield (wheat, rice, etc.,) in the markets.

as were prior to the imperialists' arrival. However, Russian authorities made some changes in the system of the collection of this obligation. Before these changes, the local authorities calculated *kheraj* lands. Group of people such as *mulla* (literate person), *aryk-aksakal* (elderly person) and *mirab* (water supplier) examined every piece of land in order to allocate to the owner certain amount to be paid as a *kheraj*. In this way the so-called team made a list of the whole area that was required to pay *kheraj* for the upcoming term. This complete *kheraj* payment due list was then sent to *Bek* (Governor of the District), where any person on this list, had a chance to ask with valid reason (usually financial problems) to omit his obligation to pay *kheraj* from *Bek* directly. After *Bek* issued final ordinance for *kheraj* collection no one could change it.

Kheraj collection during 1866 in Tashkent reduced dramatically as compared to the previous year. Its amount before the Russian conquest fell from 180.000 rubles in 1865 to 80.000 rubles in 1866. The reason for such drastic change was the structural changes that Russians brought into this collection system (Sbornik, 1867).After few years of decline in the collection of the *kheraj* amount, changes brought by Russians increased the revenue for their budget. The changes could be seen in the appointment of the *aksakals* (elderly of the village) who were directly passing the collected money to Russian authorities that ruled there (Sbornik, 1875). Prior to 1871 that is before Russians brought changes into *kheraj* collections system, it was managed by the *amlakdars* (local leader to collect zakat) appointed by the *Bek*.

2.2. Zakat on Trade

Zakat on trade was one of the most common zakat types collected in this region since long. Silk Road routes crossed the cities of Bukhara, Samarkand and Tashkent enabling these cities to play the role of a bridge between East and West for centuries. In the above-mentioned metropolises trade was flourishing and goods from different parts of the world were exchanged and traded. Spices from India, silk from China, Russian factory produced goods, such as copper kitchen tools, hammer and *samovars*[6] were among the highly demanded articles. Caravans were stopping in the above cities bringing a variety of goods, which were traded and exchanged. Zakat on trade was imposed on the goods that intended to be exported to various parts of the world and traded in Central Asia. Each caravan had to visit Zakatchi giving exact amount and destination of the goods. Owner of the caravan dealt with *Zakatchi* (local Zakat collector) who then calculated zakat based on 2.5% of whole amount of the goods to be exported. *Zakatchi* gave receipt to the owner of the caravan so that he could proceed with his journey and show it on the way if any other zakat collector met him to prove that he had paid zakat.

Additionally, the owner of the caravan paid for every camel an extra 20 *kopeek* (Russian cent) in order to receive the right to carry goods in the Kokand Khanate area

[6] Samovar is a traditional Russian huge teapot made of steel where tea is kept hot for few hours.

without paying such an amount for a year. Zakat was paid once a year, however, if the number of traded goods increased in less than a year, the owner was obliged to announce to the *zakatchi* his increased goods' amount and pay additionally for the increased part of the zakat amount due. The merchant, who brought his goods to trade again within a year, kept his caravan outside the city and met *zakatchi* and if he had paid his zakat due earlier that year, *zakatchi* only re-calculated his goods amount and compared with his last zakat payment goods' amount. In case, if goods' amount increased as compared to the last zakat paid time, the merchant had to pay zakat for the increased potion of his goods only (Sbornik, 1867).

In the beginning, right after the arrival of the Russians, this system of the zakat collection underwent slight changes in the collection aspect, where Russian authorities appointed special officer in Tashkent and in other cities a person who was head of the local population to supervise zakat collection system together with the old zakat collectors.

2.3. Lands and its Tenure Types in Central Asia

According to Islamic Law, in Central Asia, lands were divided into two types: cultivable and non-cultivable. Cultivable lands are also divided into cultivated and uncultivated ones. Cultivated lands are further divided into categories of *ushri, kheraji and mamluki.* Whereas, uncultivated ones were in the hands of the state and could be distributed to anyone who was willing to cultivate it. Uncultivated lands are *mulki khurra khalis* and will be discussed in details further. *Ushri* and *kheraji* may be sold, dedicated or endowed by their owner. In case of the death of the owner, these lands can be inherited in accordance with the existing laws. If those lands are not cultivated within three years, the government confiscates them. The rights for the *ushri* and *kheraji* land were fully secured with the condition that owner cultivated them on regular basis. *Mamluki* lands were under the government and in the users' hand while they cultivated it. Those land cultivators were considered as renters from the state. The right to exploit *mamluki* lands did not give users full rights to inherit them or use them for a lifetime. According to Local Muslim law these lands may be passed conditionally from father to son. Our research focus is Samarkand *oblast* in Zerafshan valley. In Zerafshan valley lands are divided into following categories: *Mamluki (Amlaki), Milk Ushri, Milk Kheraji, Waqf* and *Milk Khurra Khalis.* Most of the land tenure were*Amlaki.* All types of the land tenure were imposed with zakat or taxes except *mulk khurra khalis* and *Waqf*. Here are the zakat and tax rates imposed on these lands:

2.3.1. *Zakat* on *Ushri* Lands

These lands division occurred after the Muslims conquered new lands and distributed them to the Muslim population for them to cultivate various crops. Zakat *ushri* was of 1/10 of the crop's yield from these lands, considered as *ushr* from crop, and not tax on land.

2.3.2. *Tax on Kheraji Lands*

These lands, after the Muslims' conquest.were left to the local population. Taxes collected from these lands were considered as *kheraj*. There were two types such as *kheraj- mawaziv*, which had a pre-determined and constant rate and *kheraj-maqasimah*, its rate was proportional to the amount of the yield.

2.3.3. Tax on *Mamluki (Amlaki)* Lands

The government rented these lands to the cultivators on the rental paid on *kheraj* basis or on the basis of special land payment of *tanap*[7] basis. The rate was ranging from 1/5 to 1/2 of the yield amount. *Tanap* lands usually were under *waqf* basis and their profit was spent on the religious purposes such as maintenance of the *madrasa* and other establishments.

2.3.4. *Mulk Khurra-Halis* (Lands Free of Ownership and Free of Tax)

This type of land was characterized with the exclusion from payment of *kheraj* or other types of taxes while the user of this land exploited it. This land could be obtained either with payment or with receding part of the land to the government.

2.4. Trade with Russians before their Conquest

One of the main reasons for the conquest was trade opportunities of Russians in Central Asia. Central Asia as a whole and specifically location of the cities Bukhara, Samarkand, Tashkent and Kokand were attractive economically for the Russian empire and served one of the main reasons for the conquest. There were many other reasons; however, trade remains our focus because our research is related with zakat on trade specifically and zakat system in general. Trade played the most vital role in the khanates of the Bukhara, Khiva and Kokand's budget formation. The Russians came to know that British goods started to expand in the Central Asian markets in the early-18th century. Hence Russians were intimidated by this occasion and actively started to contemplate plans to penetrate into the above mentioned markets not only using trade chances but also conquering these lands in order to draw clear line and stop British movement towards north.

A letter of the Orenburg military-governor Perovskiy V.A. to the head of the Asian department of the Ministry of the Foreign Affairs Rodofipikin K.K. of September, 26 of 1833. Due to the foreign trade situation in our frontiers with Central Asia, it is very crucial for us to receive accurate and substantial information about their internal affairs of all their regions (Demezon & Vitkevich, 1983). Later on, Governor showed his concern regarding the appearance of the British goods in huge amounts in the Central Asian markets that were produced in Afghanistan and India. Moreover, at

[7] *Tanap*-land measurements usually 1 *tanap* equals to 40 meters. Internet Source: http://n.ziyouz.com Accessed on 12.09.2017.

that time some British travelers visited Bukhara such as William Moorcroft and George Trebeck[8]. Russians were concern regarding their external trade characterized by their relative lagging behind industry-wise and technologically their counterparts from European empires such as Britain. Due to the above concerns, the Russians held on to the Central Asian market as a chance to; firstly, reduce the British market expansion towards Central Asia; secondly, increase their influence in these Central Asian markets and dominate there in order to get access to the new markets and gain material wealth (cotton, gold, silk and agricultural produce) through conquering Central Asia.

First of all the Russians were interested in Bukhara Emirate – largest country with highest population rate situated in Central Asia as well as centrally located geographically (Demezon & Vitkevich, 1983). Russian empire's trade ways to India, Persia and Afghanistan passed through Bukhara emirate. Merchants of Bukhara were very much active in the Russian markets, playing an important role in the economic cooperation between Russia and Bukhara. Bukhara played a crucial strategic role in the Russian trade with other Asian countries such as India, Persia and Afghanistan.

3. Zakat System in Malaya

3.1. Zakat Practices of Pre-colonial Malaya

Zakat practices in Malaya exist since the early stages of the arrival of Islamic faith there. Prior to the colonial rule zakat system was localized and its practices varied comprising many characteristics of the local traditions (*adat*). "The payment of zakat during pre-colonial period was not administered via formal framework. It was traditionally performed by the delivery of goods to religious teachers who would later distribute them in accordance with the need of available *asnaf* (zakat beneficiaries) (Rahman, 2012). "During this period, zakat was informally collected at village level and paid directly to religious teachers. The collections were then distributed to villagers who were in need of financial assistance (Halim, 2015). Zakat was paid voluntarily to the respected profession holders such as religious teachers, doctors and hajis. Such practices did not fulfill essentials of the zakat, which was prescribed to be given to the eight *asnaf*. Instead, it was given to the people who had more wealth than others do. In the villages, zakat was main source for the religious institutions such as *pondok* and religious schools as well. *Pondok* schools were very popular in Perlis, Kedah, Perak

[8] George Trebeck (1800-1825) was born in Middlesex, England in the year 1800. He moved to Calcutta,West Bengalcirca 1815 with his father Charles Trebeck and brother of the same name. George Trebeck, who was trained as a solicitor, was recruited by William Moorcroft at the age of nineteen as his geographer and draftsman and second in charge of an exploratory expedition which was to take him through the Himalayan provinces of Hindustan, the Punjab, Ladakh, Kashmir, Peshawar, Kabul, Kunduz, Bokhara and eventually lead to his death. George Trebeck perished on his first and only expedition with William Moorcroft on August 30, 1825 in Shah Merdon, Afghanistan.

and Kelantan. These schools were run by the Malay *Ulama* and they did not receive any government support (Yassin,1957).

Zakat was mainly of the two categories, one was agriculture and another was zakat *al-fitr*. In Malaya, zakat was limited to the above categories and the local imam allocated most of the amount to the maintenance of the mosque, salaries and to the *asnaf*. This practice did not benefit the people who were really entitled to zakat. The poor and the needy very seldom got their share of the zakat paid by Muslims to these people (Yassin, 1957). It is important to note that poor and needy portion was the least. "Practice diverged considerably from the theory in different Muslim lands. In most cases, the yield was not applied according to the law; the collectors themselves, or the *kathis*, kept the larger part.

3.2. Zakat System in Colonial Era

During the first quarter of the 20th century, zakat system underwent changes and many zakat institutions centralized which allowed establishing control over collection and distribution of the zakat. A special body known as *Majlis Agama Islam Negeri* (MAIN) administered all Islamic and Malay customs related matters (Rahman, 2012). The most significant impact that British colonial policy had on the development of zakat in Malaysia was the establishment of bureaucratization. The individual states in a centralized fashion through a single government-controlled institution gradually managed the zakat system (Steiner & Lindsey, 2012). Zakat system administration also came under the MAIN. The first state to regulate zakat under the new situation was Kelantan. In 1915, Kelantan first established the Kelantan Council of Religion and Malay Custom (*Maljlis Ugama dan Isti'adat Melayu* Kelantan). British system of administration was one of the factors that led to the establishment of the *Majlis Ugama* in Kelantan, which afterwards as a chain reaction led other states to follow their counterpart.

The role of the local imams started to be less influential with regard to all matters, including collection and distribution of zakat. From the perspective of the imams the creation of the *Majlis* not only subordinated them to central authority but also transformed them into servants of a powerful bureaucracy without the benefit of fixed salaries (Muhammad, 1993). Compared to pre-colonial era zakat system became organized and centralized in a way that imams had to pass part of the collected zakat to the *Majlis Ugama,* some to the poor and needy and some portion to the maintenance of the *madrasah* and mosques. Only in mid-1950 in all states of Malaya, Zakat system became harmonious part of the whole system and it was backed with legislative measures.

3.3. Zakat System during Colonial Rule (Kelantan Experience)

After the British took power into their hands, Zakat and other Islamic practices were left to the Muslims. However, the British general principles of non-interference in religious matters did not necessarily imply that the British rule had no effect on Islam in the Malay states (Muhammad, 1993). The whole system of the zakat administration with the help of the British administration underwent changes as compared to the pre-colonial period, zakat related matter came under the Malay rulers (Muhammad, 1993). In Kelantan, in 1917, *Majlis Ugama* made local imams to surrender 7/8 of the collected zakat *al-Fitr*. In 1916, 95% of the *Majlis Ugama's* income formulated from the zakat collection and the peasants were main zakat payers (Hasan, 1987). In such circumstances, local imams opposed to surrender the amount to the *Majlis Ugama*, expressing their mistrust in dealing with the zakat distribution by this authority. After 2 years, in 1919, in order to influence *imams Majlis Ugama* decided to reduce the share for them up to 4/5. However, many *imams* still refused to obey for some years to come. This was evident in the 1924 notice when *Majlis Ugama* appointed zakat inspectors over the *imams* (Muhammad, 1993). The local village, arguably, became disenfranchised in the process of zakat conceptualization. Its only input in the discourse was limited to the actual payment of zakat. This resulted in a re-conceptualization of zakat at the local level with people now calling it 'zakat raja' (ruler's zakat) (Steiner, 2012). Local people's anger was understandable, as zakat was not distributed locally in the village for their needs such as maintenance of the local mosques and distribution to the poor among them. In later stage of the zakat system *Majlis Ugama* Act of 1938 put *imams* into poorest position where the previous share kept for the maintenance of the mosques and madrasah was abolished. With this, all *imams* were passing all collected zakat funds to the *Majlis Ugama* in order to receive their salaries.

3.4.Zakat on Rice (padi)

In Malaya, due to weather conditions rice is one of the main cultivations together with rubber and coconut plantations. Hence, zakat collections mainly consisted of zakat on *padi*. In Malaya, zakat was usually limited to agricultural produce, generally, unhusked rice which was delivered to the local imam who assigned it or preceded its sale, for mosque maintenance, repairs, salaries, the local poor and so forth (Yegar, 1979). Zakat was not posed on coconut plantations and rubber. Zakat on rice or *padi* is paid on the basis of 10% of the yield as it is prescribed in the Islamic law. Interestingly, the rice growers of the state Kedah and Kelantan pay only half of the zakat due on *padi*, whereas the payer himself distributes another 5% to the respected recipients. In Kedah, state collected zakat from *padi* is distributed among the recipients, for example, if there is 32 *gantangs*[9] of rice to be distributed among the respected recipients the ratios will be as follows:

Table 1.

[9] 1 *gantang* is equal to 2.27 kg. In Malaysia until 1982, traditional Malay measurement units were in use. *Malaysia at Random* (2009), Edidtions DIdier Millet Sdn Bhd Kula Lumpur Malaysia. P.79.

Distribution ratio by the Zakat department of Kedah among asnaf

Asnaf	Gantangs	Asnaf	Gantangs	Total
The Amils	8	The converted	1	
In the cause of Islam	8	The slaves	8	
The poor	3	The wayfarer	1	32 Gantangs
The needy	3	The debtor		

The zakat Department in Kedah expects the farmers to distribute the uncollected amount left with him according to the following ratios:

Table 2.

Distribution ratio by the zakat payers themselves to the asnaf

Asnaf	Gantangs	Asnaf	Gantangs	Total
The Amils	-	The converted	7	
In the cause of Islam	-	The slaves[10]	-	32 Gantangs
The poor	5	The wayfarer	7	
The needy	5	The debtor	8	

However, the department takes no steps to ensure that such distribution is carried out. From the above tables, it is clear that in Kedah Zakat collection and distribution is arranged on the dual system basis, where the responsibility between state and person is shared equally with regard to the distribution of the zakat to the lawful recipients. This case gives room to questions such as zakat payers' individual responsibility towards zakat distribution might have increased due to trust by the state and vice versa when zakat payers also have trust on the state zakat collectors that they will distribute funds accordingly among *asnaf*.

3.5. Zakat Al-Fitr (*fitrah*)

Zakat *fitrah* is collected in all states except Kedah. The amount of *Fitrah* is different from one state to another. "In Perlis and Selangor the amount of zakat *al-fitr* due per person is 6 *katis* (approx. 3.6 kg)[11]. In Johore and Perak it is fixed at 3.75 *katis* and in Kelantan it is 6 *kati* for 2 person, however, if the number of people who are paying is 3 then the *fitrah* is 12 *katis* (Yassin, 1957). *Fitrah* is paid in cash also and depends on

[10] Although there are no slaves in Malaya the authorities in Kedah still collect their share and its been used for the other purposes.

[11] *Kati* is a unit of weight measurement in Malaya.1 *kati* equals to 604 grams. In Malaysia until 1982, traditional Malay measurement units were in use. (See, *Malaysia at Random* (2009), Editions Didier Millet Sdn Bhd Kula Lumpur Malaysia.P.79).

the prices for rice.

3.6. Zakat Management in Selangor

Zakat management in Selangor is under Zakat Unit of Religious Affairs. The nature of property upon which zakat is payable in Selangor is divided into two categories, namely zakat/*fitrah* and zakat *harta* or property zakat. Produce such as *padi*, gold, silver, currency, merchandise, goods, and the breeding of livestock are all part of zakat *harta* (Khalid,1988).

Zakat collection and distribution were organized in a systematic manner in Selangor state at the beginning of the mid-20th century by the Muslim Law Enactment, passed in 1952 was ''Scheme for the collection of the zakat and *fitrah''* (Selangor Secretariat, 1953). This Enactment enabled the Council of Religion and Malay Custom to collect zakat and *fitrah* on behalf of H. H. the Sultan. This establishment made the institution responsible to collect and distribute zakat in Selangor.

The scheme for the collection and the distribution of the zakat and *fitrah* are meant to clarify the roles and responsibilities of the each aspect, which is required to make sure that zakat is collected and distributed in a fair and timely manner. According to the above Enactment, following are the sources which fall under the zakat payable:

3.6.1. Cereal Crops. They are *padi* and to a small extent maize and the rate is 10% of a crop of 375*gantangs.*

3.6.2. Business Assets of Muslim Firms. Business assets of Muslim firms, partnerships joint stock companies. The rate is 2.5 % of the declared and certified assets at the end of the financial year of the business.

In Selangor, the accountant at the department of Religious Affairs is in charge of the administration of zakat and *fitrah* in the State. He is assisted by a Supervisor of zakat stationed at Tanjong Karang, Inspector of zakat and *fitrah* and two clerks. These officers, with the exception of the supervisor of the zakat, are employees of the Religious Affairs department. The supervisor is nominated by the Council of the Religion and Malay Custom and receives a monthly allowance of one hundred dollars.

3.7. Methods of Collection

Since cereal crops are localized in the rural areas the collection of zakat from this source was done through local bodies. The oldest and most respected institutions were the Mosques. They were organized on modern line, i.e. they were given proper constitution and a committee elected annually on democratic principles under the constitution. The committee members were responsible for taking crop census and assessed zakat payable by each cultivator in their specific area. Long before the harvest season the committee appointed *amil* who received a special letter of appointment under the Enactment and specific area for his responsibility to collect zakat on behalf of the

Majlis. *Amil* was given counterfoil receipt book. Receipt was issued for each zakat payer. Zakat was paid either in cash or in kind. His responsibility was to maintain account of the area under his responsibility. The collected zakat amount in cash had to be deposited in the local Treasury in the name of the *Majlis* and in case if zakat was paid in kind he had to hand it over to the local body committee, which was eligible to dispose it to approved *padi* buyers. Zakat collector's wage was based on the commission with the rate of 1.5% to 2.5% of the total collected amount. Government also kept 15-20% of the collected zakat amount in order to pay salaries, pensions, travel expenses and stationery of the people involved in the collection of the zakat (Selangor Secretariat, 1953).

3.8. Methods of Distribution

As the method adopted in the collection of the zakat, the distribution process also occurred in the same way, through the local committee. They are supposed to know better who are eligible to receive zakat in their respective areas. Receipt for each zakat distributed was issued and during the payment to the respected recipient local *Penghulu* was invited to look after the process.

4. Findings

4.1. Differences

Zakat practices of the Malaya and Uzbekistan has similarities and differences. For instance, differences in the collected zakat types can be seen, where in Malaya zakat was mainly collected from agriculture (mainly *padi*) and business, whereas in Uzbekistan zakat practices were common in agriculture (mainly wheat and cereal crops), business (trade), livestock and in other types. Another difference can be seen in the collection from the agricultural produce of fruits and vegetables where in Central Asia there was no minimum level (*nisab*) for the farmer to reach in order to pay zakat on his yield due to difficulties in the assessment of the estimated amount to be harvested. He paid fixed amount of the money to the collector for example, for one *tanab* of fruit trees and grape trees in a year payment was 10 *kopeek (russain cent)*, for one *tanab of* cotton produce 1 *ruble* (Russian currency) and 40 *kopeek.*

4.2. Similarities

The collection methods were similar in both countries even after the colonial powers changed zakat system. For example, in Uzbekistan Russians established zakat supervisor, who was appointed by their local authority to control the actions of the local zakat collector. Similarly, in Malaya, after the British came into the reign, new zakat collection system underwent changes which included new appointment, zakat supervisor from the local authority was appointed to make sure that zakat collections and distribution were in a proper manner and in accordance with the Islamic law.

In the similarities, we can emphasize the *Amils'* responsibilities. Both countries' *amils* were similarly acting as agents who were given specific area to make lists of zakat payers with the details of their lands and expected crops. They also distributed the zakat collected to the respective recipients of the zakat in their respective areas.

Both British in Malaya and Russians in Central Asia targeted more on materialistic wealth accumulation such as in Malaya tin, copper, rubber and palm and in Central Asia cotton, silk and agricultural produce together with the trade opportunities with Afghanistan, India and Iran. However, Russian activities and efforts led eventually in abolishing zakat practices in Uzbekistan, whereas in Malaya British helped to create centralized zakat system with proper rules and regulations.

5. Conclusion

In order to reveal the true nature of the topic more research is required to be done. This humble research tried to give an overall picture of the zakat system and its practices and changes which were brought by the imperial powers and how they dealt with zakat practices during the colonial era in Malaya and Uzbekistan. Their attempts to create a modern system of taxation and zakat, as they perceived, resulted in broad changes in the structural level of these systems. Both Malaya and Central Asia had colonial experience where the influencing powers put their own interests over the local socio-economic life of the Muslim community and brought changes that at the end shaped the new society that had mixed traits from the colonialists' influence as well as traditional inheritance. Even though, British agreed not to intervene in religion and customs of Malay community, they indirectly tried to influence them through education as well as economic activities, which were targeted to achieve only economic welfare of the British Empire. However, it is unfair to state that British intervention was not always harmful to the Malaya, a good example again is the establishment of the organized Taxation and Zakat system. In the case of the Central Asia, Russians dealt with their colonized lands in a slight different manner due to the local populations strive to keep their own traditions and unwillingness to undergo any changes with regard to any aspect of their life. In the light of these facts, the Russians had no choice other than to abolish pre-colonial systems of administration, especially with regard to the zakat system. Towards the end of the rule of the British, Malaya managed to establish a centralized and government controlled zakat and taxation system, whereas in Central Asian countries, Russian rule totally eradicated zakat system and replaced it with the conventional taxation system. Later on new political powers arrived into Russian empire in 1917. They had ideologies such as communism, which was contradicting the life style, culture and traditions of the Central Asians, and this reign only lasted for 70 years.

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A Sustainable Islamic Microfinance Model in the True Spirit of Islam

Dr. Talat Hussain[1] Muhammad Nadeem Khalil[2]

Abstract

Microfinance is considered an effective tool in alleviating poverty all over the world. The objective of this paper is to develop a sustainable Islamic Microfinance model in the true spirit of Islam. Despite its importance, the microfinance sector accounts less than 1% of the overall Islamic Finance industry although 1.2 billion of global population is living below poverty line (earning less than $2 per day) and 44% of which are living in Muslim countries. Similarly the current practices of Islamic Banks and Islamic Microfinance Institutions are based on the principles of materialism rather than the concept of *falah* (success in this worldly life and hereafter) due to which they have failed to achieve the objective of fair distribution of wealth in the society and alleviating poverty from the society. Therefore, in this paper an Islamic Microfinance Model based on the moral and ethical values of Islam (Piety, Justice, Benevolence, Cooperation, equality, selflessness avoidance from materialism) is developed. This model proposes Musharakha, Modarabah, Wakalah and Qarz-e-Hasana as the ideal modes of Islamic Microfinance because legitimacy of these modes of financing is beyond any doubt. In this Islamic Microfinance Model various steps are proposed for microfinance institutions, central bank and government. If this model is implemented in true letter and spirit, it can result in balanced growth and bring harmony in the various segments of the society by reducing poverty, increasing employment and fair distribution of wealth among them and thus contribute in the economic development and social well-being of the people.

Keywords: Islamic Microfinance, poverty alleviation, sustainability, materialism, falah.

Introduction

Islamic Finance has made a tremendous growth in the past few years all over the world (Shaikh, 2012). There are more than 300 Islamic Financial Institutions (IFIs) globally and the total assets of Islamic Finance have crossed $1.9 trillion (IFSB, 2016). It is expected that the total assets of Islamic Finance will cross $2.7 trillion by the year 2017. However, if we look at the size of microfinance loans, we come to know that it is very small and the total assets of Islamic Microfinance were only $1.8 billion according to Microfinance Information Exchange (MIX) statistics in year 2014. According to the Oxfam report, 80 richest people in the world own as much wealth as the 3.5 billon poor people and the gap between rich and poor is increasing with the passage of time. So there is a dire need of emphasizing on the microfinance for eradicating poverty and social well-being of the most deprived segment of the society. However, despite the

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importance of microfinance the microfinance sector accounts less than 1% of the overall Islamic Finance industry although 1.2 billion of global population is living below poverty line (earning less than $2 per day) and 44% of which are living in Muslim countries (GIFR, 2016).

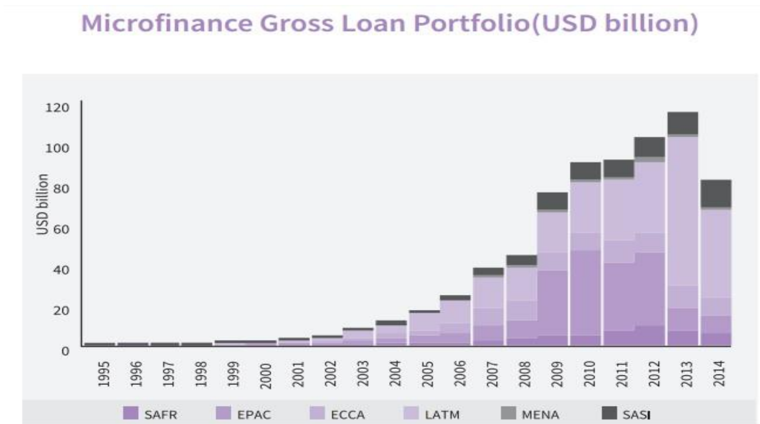

Figure 1. Microfinance Gross Loan Portfolio

Source: Microfinance Information Exchange (MIX) Database 2015, IFSB Secretariat Workings.

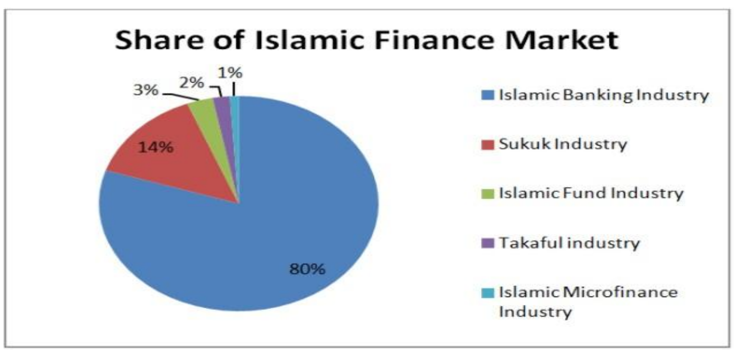

Figure 2. Share of Islamic Finance in the Market
Source: AlHuda Center of Islamic Banking & Economics (CIBE), 2017

Here it should be noted that the contributions of Islamic Banking in overall Islamic Finance industry is about 80% which means that the main focus of Islamic Banks is advancing loans to the corporate sector instead of advancing loans to the poor ones. That’s why most of the people are not satisfied with the performance of Islamic banks with respect to their contribution in alleviating poverty and social well-being of poor people (Chaudhry, 2006). Islamic banks have failed to achieve the objective of fair distribution of wealth in the society (Mansoori, 2011). The people argue that the philosophy of Islamic banks is based on materialism rather than on the concept of *falah* (success in this worldly life and hereafter). They believe that the sole motive of Islamic banking is to make profit in the name of Islam. The modes of finance adopted by Islamic banks (such as *Murabaha*, *Ijara*, *Salam, Istisna*, *Dimishing Musharakah*, *Bai Musawammah*) are nothing more than legitimizing the interest through various *Hiyals* (plural of term *Hila* which means tricky solutions to difficult problems and clever uses of law to achieve legitimate ends) and *Talfiq* (borrowing between schools of law to reach intended objectives) as they think that various modes of finance introduced by Islamic banks are Shariah compliant with respect to their contract and procedure but they ignore the true spirit of *Shariah* (Mansoori, 2011).

Keeping in view the above mentioned issues in conventional financing as well as overall Islamic banking, there is a need to develop an Islamic Microfinance Model which should be based on the true principles of Islam instead of exploiting the people in the name of Islam. Here it should be noted that there is a sustainability issue for the models being practiced on the basis of Qarz-e-Hasana, like "Akhuwat" in Pakistan. The question arises how we can tackle these problems so that we can develop a sustainable Islamic Microfinance Model in the true spirit of Islam which can contribute to the social well-being of the people by alleviating poverty, keeping in view the true spirit of Islam and Maqasid-e- Shariah. The present study is an attempt to achieve this objective.

2. Problem Statement

Total assets of Islamic Finance have crossed $1.9 trillion but the total assets of Islamic Microfinance are only $1.8 billion which are less than 1% of total Islamic Finance assets. Now the questions arises that "Is Islamic Finance only for rich people or there should be some efforts to finance the poor people for eradicating poverty and balanced growth of various segments of the society? Is Islamic Finance based on the concept of Falah or materialism? Are current practices of Islamic Banks in true spirit of Islam or there is a need to develop a new Islamic Microfinance model keeping in view the true principles of Islam? The present study is an attempt to answer these questions that how we can tackle these problems so that we can develop a sustainable Islamic Microfinance Model which can contribute to the social well-being of the people by alleviating poverty.

2.1. Objectives

The objectives of the paper are:

1. To develop a sustainable Islamic Microfinance Model, which can contribute to the social well-being of the people by alleviating poverty, keeping in view the true spirit of Islam and Maqasid-e-Shariah.

2. To develop an Islamic Microfinance model to enable the poorest of the poor segment of the society in earning their livelihood.

3. To develop an Islamic Microfinance model based on the concept of Falah instead

of materialism.

4. To develop an Islamic Microfinance model in the true spirit of Islam instead of exploiting the people in the name of Islam.

5. To develop a sustainable Islamic Microfinance Model for increasing employment by fair distribution of wealth among various segments of the society.

2.2. Significance

This study helps us in developing a sustainable Islamic Microfinance model in the true spirit of Islam which can contribute to the social well-being of the people by alleviating the poverty, keeping in view of true spirit of Islam and Maqasid-e-Shariah. In this study an Islamic Microfinance model is proposed which is based on the concepts of Musharaka, Modaraba, Wakala and Qarz-e-Hasan embedded with the moral and ethical values of Islam (Piety, Justice, Benevolence, Cooperation, equality, selflessness, avoidance of materialism). So this study helps in reducing poverty and increasing employment by fair distribution of wealth among various segments of the society and thus contributing in the economic development and social well-being of the people. In this model various steps are proposed for banks, central bank and government which help the various stakeholders and policy makers in developing a sustainable Islamic Microfinance model in the true spirit of Islam.

3. Literature Review

Microfinance is defined as: "Small loans that help poor people who wish to start or expand their small business but, are not able to get banks to lend to them" (World Bank Report, 2007). Microfinance Institutions (MFIs) provide loans to the people who don't have access to the commercial banks due to the non-availability of sufficient collateral (Hartarska, Caudill, & Gropper, 2006). The importance of Microfinance Institutions (MFIs) can be understood from the fact that almost 44% of the conventional microfinance client live in the Muslim countries (Mughal, 2011).

There are various microfinance models, the most important among those are Grameen Bank Model, Credit Union or Cooperatives Model, Self Help Group Model and Village Bank Model (Obaidullah, 2008). Graduation Model introduced by BRAC (Bangladesh Rural Advancement Committee), Social Islami Bank Limited (SIBL), Baitul Maal wa Tamweels (BMTs), Community banking model and Grameen La Riba Model are the other important models which are successfully implemented in various countries (Mannan, 2007). In Grameen Bank Model, financing is made to a group of people who provide guarantee of each other. This group usually consist of five people on average who are trained about the basic element and financing requirement of the loan disbursed to them. The repayment of loan is considered the collective responsibility of all group members. Credit Union or Cooperative Model focuses on mutual benefit and is based on non-profit financial cooperative which is owned and controlled by its members. Loans are provided to the members on non-profit basis. In *Baitul Maal wat-Tamweel* (BMT) Model, being operated in Indonesia, Qarz e Hasan and charity based social services are provided to the poor people on non-profit basis. Community Bank Model is based on the concept of local bank in which all the employees working belong to the same geographical area and therefore know the people in the community and can serve them better. In Micro Banking, various banking services to meet the micro financing needs of individuals are provided in rural areas. These facilities include micro lending, micro savings, money transfer, micro insurance etc (Obaidullah, 2008).

The most important questions regarding a successful Islamic Microfinance Model is its sustainability as without the sustainability microfinance model cannot be successfully implemented. Sustainability of microfinance model can be viewed in two perspectives: its economic and social impact. In economic perspective, a microfinance model should contribute in increasing income, poverty alleviation, asset building while its social impact should be viewed with reference to its outreach, skill development, knowledge improvement, family empowerment, religious adherence etc. (Fernandez, 2006). Robbani (2007) argued that Grameen Bank Model cannot be recognized as ideal because it charges higher interest and failed to alleviate poverty. He emphasized on the using of Sharia based models of Islamic Micro financing which are ideal to alleviate poverty from a society. He argued that the collection of Zakat in organized form can help in alleviating poverty. Mannan (2007) compared Microfinance Model of Grameen Bank with Social Islam Bank Ltd. Model and concluded that Grameen Model is not helpful in reducing poverty while the Social Islamic Bank Ltd. Model is helpful in reducing poverty and equitable distribution of wealth in an economy.

Most of the Microfinance Institutions (MFIs) charge huge interest on their loans which put an extra burden on the poor people. Therefore, more attention is needed to devise an Islamic Microfinance Model which is based on the concepts of justice, piety, brotherhood and mutual cooperation instead of exploiting the poor people by charging higher interests. The approach focuses on social benefit rather than profit maximization.

According to Segrodo (2005), Musharrakah, Mudaraba, Murabaha and Qarz e Hasana are the most important methods of interest free financing. In Mudaraba there is no interest rate charged, instead capital provider and the borrower decide a profit and loss sharing basis in which the Mudarib (borrower) carries out the affairs of the business and the financial institution provides capital and the profits are shared as per agreed ratio. However, in case of loss the Mudarib does not share in the loss of the business. On the other hand in Musharakha, two parties provide capital and profits are shared as per agreed ratio and the loss is shared according to the share of capital of each individual investor. In Murabaha, the financial institution first purchases the assets and then sells them to the customer on higher price after adding profit (Habib, 2005). As far as the principle of Qarz e Hasana is concerned, no profit or interest is charged on the loan advanced and the borrower returns the loan on agreed date. Lender does not force him to pay back the loan earlier than the stipulated date (Iqbal & Mirakhor 2007).

4. Role of Islamic Microfinance Institutions under Proposed Islamic Microfinance Model

The main source of revenue for a bank is its deposits. The more deposits the greater the ability of a bank to invest those deposits and generate profits. In a true Islamic Microfinance Bank, there should be only four types of deposits:

Current Account
Investment Account
Donations/Charity Account
Zakat Account

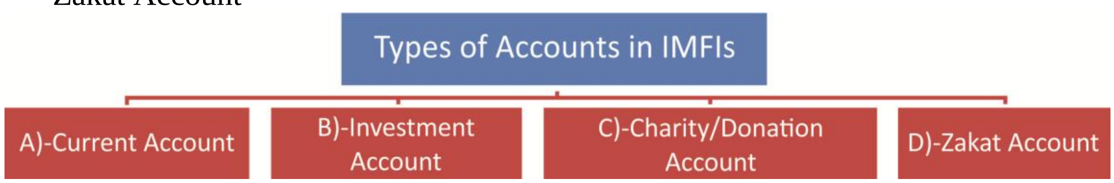

Figure 3. Types of Account in IMFIs

4.1. Current Account

An Islamic Microfinance Bank will receive current deposits on the basis of Qarz- e-Hasan. The bank will receive nominal service charges for providing various facilities to their customers like checking facility, Online Transfer facility, ATM, issuing Demand Drafts and providing locker facilities etc. 80% of the deposits in these accounts will only be used for providing Qarz-e-Hasanah in order to reduce poverty in the country while remaining 20% will be used by the bank for meeting its liquidity requirements. Local community will be given preference in providing Qarz-e-Hasanah. However, after meeting local needs, these funds would be transferred to other areas also. In this regard each bank branch will be responsible for keeping a record of such deposits that will be shared and consolidated at Tehsil level in order to ascertain the total deposits in these accounts and identify people those can be given Qarz-e-Hasanah on need basis. Skilled workers who want to start their own business should be given preference in this regard.Qarz-e- Hasanah can also be provided for skill enhancement and training programs. A special committee comprising honorable persons of the local community can be formed in order to identify the deserving people and check the fair distribution of such funds among deserving people. Serving local community on priority basis will create a sense of satisfaction regarding the fair use of the savings of the people and will encourage them to save more and keep these saving in bank for serving the local community. Government of Pakistan will provide guarantee of such Qarz-e- Hasanah loans to the banks and also to the account holders. However, in order to keep the bank interested a strict penalty should be imposed on banks if non-performing loans in Qarz-e-Hasana category exceed certain limits.

Figure 4. Types of Account in IMFIs

4.2. Investment Account

As far as investment accounts are concerned, the role of Islamic Bank will be that of a Wakeel and Partner (in Musharkah). In this regard, the following banker-customer relationship will be created:

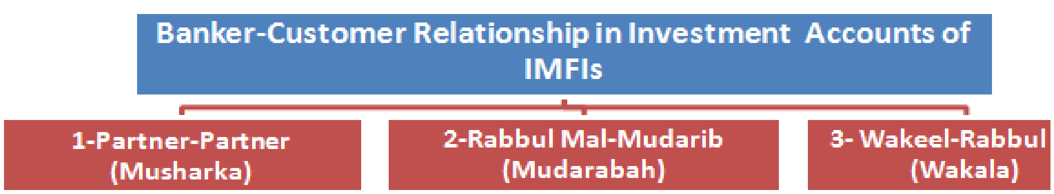

Figure 5. Types of Account in IMFIs

4.2.1. Partner-Partner (Musharkah)

In this case the bank and depositors will finance a project jointly. Both the bank and depositors will be Rabbul Mal and the customer requiring finance will be Mudarib (he may also be partner if he contributes his capital). In this case the bank will contribute from its own profits but not from depositor's fund. Profit and loss will be shared according to their invested capital or agreed formula. As a Mudarib, the customer requiring finance will not be liable to financial loss.

4.2.2. Rabbul Mal-Mudarib (Mudarabah)

In this case the bank will be Rabbul-Mal and provide finance to its customer who will act as Mudarib. Profit will be shared between the bank and customer on agreed ratio. However as Mudarib, customer will not share in the loss of the business. It is to be noted that the bank will provide its own capital or profit instead of using the money of its depositors in the current or investment account. For example, if a customer wants to purchase machinery, the bank will purchase that machinery and then will provide that machinery to the customer and will ask him to start business using that machinery after fixing the profit ratio. In case of malpractices by the customer the bank will cancel the agreement and take back the machinery from the customer.

4.2.3. Wakeel-Rabbul Mal (Wakala)

In this case bank will be Wakeel and customer will be Rabbul Mal. It is to be noted that the bank cannot be the Rabbul Mal of the deposits of the customers as these belong to the customers and not to the bank. Therefore if a person **A** approaches bank for financing a project, then the bank will provide him finance on the behalf of his customer and will charge a fixed fee in return of providing its services and investing on behalf of the customer. If whole amount of the project will be financed from the investment account (No bank's and person **A** contribution), then in this case the relationship between the customer and the person **A** will be that of Rabul Mal-Mudarib (customer being Rabbulmal and Person **A** being Mudarib) where bank will work as Wakeel for a fixed fee. Profit and loss will be distributed as per agreed ratio after deducting wakalah fee of bank. For example Mr. A approaches ABC Bank Limited for purchasing a spinning unit. ABC Bank Limited purchases that machinery worth Rs. 100,000 out of funds from investment account and fixes the profit ratio as 50:50. The business generates Rs.10, 000 as profit. Bank A deducts 1000 as his wakala fee and distributes Rs.4500 to customers and Rs.4500 to Mr. A.

4.3. & 4.4. Donations/Charity Account and Zakat Account

The amount in donation/charity account and Zakat Account will solely be used for providing Qarz-e-Hasanah and Skill Development projects for the poor people of the society in order to enable them to earn their livelihood and thus eradicating poverty from the country. So the funds in Zakat Account, Donation Account and 80% of the Current Account will be used only for providing Qarz-e-Hasanah and skill trainings to the poor people of the society which will help a lot in eradicating poverty in the country and will contribute towards the social well-being of the poor people by enabling them to earn their livelihood and support their families.

5. Trading House

As there are doubts on the legitimacy of various Islamic Banking financing instruments (discussed earlier) like Murabaha, Ijara, Salam, Istisna, Diminishing Musharakah, Bai Musawammah, so instead of using these instruments as a mode of finance, an Islamic Microfinance Bank will work as trading house and will establish linkages with renowned national and international companies. The Islamic Microfinance Bank will make agreements with these companies for supplying various goods from time to time on the demands of the customers of the banks. Whenever a customer will need a particular product, the bank will issue supply order to the concerned company which will supply that particular item to the bank and the bank will sell this item to its customer on market price on deferred payment basis. With the passage of time the customers of the bank will increase as the bank will be supplying goods on market rate but on deferred payment basis. With large number of customers, the bank will be in a position to get more discounts from the companies supplying various products to the bank and hence can increase its profit margin. Trading activities can also be done using the funds in the investment accounts and the profits will be shared with account holders as per agreed ratio.

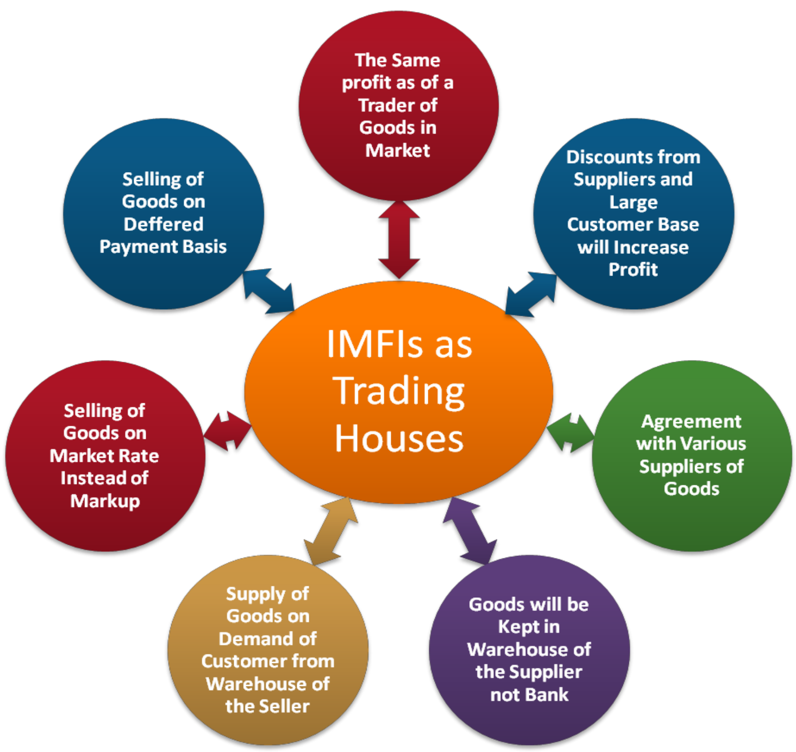

Figure 6. IMFIs as Trading House

6. Role of Central Bank under Proposed Islamic Microfinance Model

The role of central bank in stabilizing the economy is very important. In this regard central bank has to take various measures to control money supply, inflation, overseas banking sector and whole financial system of the country. Under the proposed Islamic Microfinance Model, central bank will fix financing targets for banks and microfinance institutions keeping in view the poverty and unemployment in the country. Central bank of the country as a lender of the last resort will provide funds to the banks on Qarz-e-Hasanah basis in case of liquidity crunch. 20% of the current account balances will also be available for banks to meet liquidity requirements. A penalty will be imposed on the bank not meeting the liquidity requirements and central bank will play an important role in overseeing the performance of various banks in this regard. In Islamic economic system the depositors of the bank agree to share the risk associated with their investments, so there will be no need to fix reserve requirements by the central bank as it will result in making the country's resources idle instead of effectively utilizing them. Additionally, banks will be required to put 5% of their profits as contingency reserve in order to meet liquidity crises so there will also be no need to fix liquidity requirements for the banks.

7. Role of the Government under Proposed Islamic Microfinance Model

Assuming the role of Khalifah, the Government will promote a culture of "*Amr bilmaroofwanahi ani al-munkar*" and will abolish all interest based financial instruments, laws, rules and regulations with immediate effect and introduce new laws keeping in view Shariah principles. Government by leading from the front will put great focus on promoting the moral values of Islam (piety, justice, benevolence, brotherhood, selflessness, cooperation and equality) in the society. Government will allow microfinance institutions to collect Zakat. Zakat, if utilized effectively can reduce poverty in a society to a greater extent. Additionally, current accounts balances and loans provided on Qarz-e-Hasanah basis will be guaranteed by Government in order to boost the confidence of the depositors as well as micro finance institutions.

8. Conclusions and Recommendations

The objective of this paper is to develop a sustainable Islamic Microfinance model in the true spirit of Islam. Various exiting Islamic Microfinance Models all over the world are reviewed and their viability is checked. It is observed that conventional microfinance models charge higher rates of interest from their customers due to increased risk while serving the poor which results in putting more burden on the poor people instead of helping them in coming out of their vicious circle of poverty and earn their livelihood. Similarly the current practices of Islamic Banking are based on the principles of materialism rather than the concept of *falah* (success in this worldly life and hereafter) due to which Islamic banks have failed to achieve the objective of fair distribution of wealth in the society and alleviating poverty from the society (Mansoori, 2011). Additionally, Islamic banks have not emphasized advancing the microfinance loans to the poorest of the poor segment of the society and the microfinance sector accounts less than 1% of the overall Islamic Finance industry although 1.2 billion of global population is living below poverty line (earning less than $2 per day) and 44% of which are living in Muslim countries (GIFR, 2016). Therefore, in this paper an Islamic Microfinance Model based on the moral and ethical values of Islam (Piety, Justice, Benevolence, Cooperation, equality, selflessness and avoidance from materialism) is developed. This model proposes Musharakha, Modarabah, Wakalah and Qarz-e-Hasana as the ideal modes of Islamic Microfinance because legitimacy of these modes of financing is beyond any doubt. In this Islamic Microfinance Model various steps are proposed for microfinance institutions, central bank and government. If this model is implemented in true letter and spirit, it can result in balanced growth and bring harmony in the various segments of the society by reducing poverty, increasing employment and fair distribution of wealth among them, and thus contributes in the economic development and social well-being of the people.

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The Way Forward for Islamic Banking System: A Comparative Study between Malaysia and Nigeria

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Abstract

This study sheds light on the way forward for the development and growth of the Islamic banking system. The study employs qualitative approach making use of the in-depth field interview with regulatory officers, practitioners, academicians, who are directly involved into the operations of Islamic financial institutions in two countries namely Nigeria and Malaysia. This study has policy implications for the Central Bank of Nigeria (CBN) and other stakeholders in the area of Islamic banking system. The findings of this study will be a source of reference for Nigeria and other countries in formulating a similar concept of Islamic banking system because it identifies the gap which needs to be filled in order to make the system a success. However, this research also affects the policy implications for international societies and also championing the course of financial inclusion.

Keywords: Islamic banking system, qualitative approach, way forward

Introduction

It is noted that monetary and capital markets of Nigerian banking system have considerably changed for the last several years (Ofanson *et al.*, 2010). No doubt, the weakness of traditional banking system is one of the major reasons for the failure of Nigerian banking system. For instance, according to Yakcop (2003) the conventional financial system has now produced 358 billionaires, while keeping 1.3 billion people living in absolute deprivation. Due to weaknesses of traditional banking system, Islamic banking appears as an alternative to unrestrained activities of traditional financial markets. Therefore, it departs significantly from conventional banks' behavior. Thus it must be encouraged. For instance, in a recent study by Fatai (2011), Islamic banking has grown steadily over the years. However, its popularity increased with the increasing failure of the conventional banks. In 2005, Islamic Banking was growing at a rate of 10-15% per year. The growth went up to about 20% in 2008. Expected growth in 2013 was put at 24% and this was achieved (Shabbir et al., 2015).

Keeping in view the above mentioned facts, the launching of Financial System

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Strategy (FSS) 20: 2020 by Nigeria government in 2005, regarding money market, among this blueprint's initiatives is to create non-interest banking (Islamic banking) instruments to capture huge unbanked segments of the society. No doubt, this is a signal that Nigeria is getting ready to consider Islamic banking system, but all the necessary requirements for it must be prepared for and met. On the other hand, national and international policy makers and researchers have focused on the banking industry as a key factor in causing and preventing financial and economic crises (Mahmood Nathie, 2010). Drage et al. (1998) cited by ISRA (2013) argued that the 1997 Asian banking crisis was in part a product of "*the poorly regulated and often distorted financial sectors in these countries*". Therefore, there is a need for urgent, effective and appropriate measure actions to be taken by the relevant stakeholders especially the regulators (Ali, 2007).

Thus, the purpose of the study is to examine the monitoring and control provided by the state bank of Nigeria regarding Islamic investment structure to shed light on the challenges, constraints and way forward for the development and growth of the system. Therefore, the study will have policy implications for the CBN and other stakeholders in the area of Islamic banking system. Findings of this study will be a source of reference for Nigeria and other countries in formulating a similar concept of Islamic banking system. The research will also have policy implications for international organizations such as Islamic Development Bank (IDB), World Bank, United Nations (UN) and International Monetary Fund (IMF) that have been championing the course of financial inclusion. This paper consists of six (6) sections. Following the introduction, literature review is given in section two. In section three, methodology of the paper has been given. Findings of the study in terms of preliminary findings and the way forward are provided in section four and five respectively. Section six concludes the whole topic.

2. Literature Review

2.1. Benefits and Potentials of Islamic Banking System in Nigeria

A number of theoretical and empirical researches conducted over the years have confirmed the potentials of Islamic banking in Nigeria. In addition, according to Sanusi (2011), the following benefits are easily recognized for Islamic banking system in Nigeria: the high number of Nigerian Muslims who out of religious belief choose to keep the money outside the formal banking system which has contributed to the high level of cash outside the banking system. These Nigeria Muslims will be ready to deposit their money with the non-interest (Islamic) bank. Furthermore, Islamic banking is less prone to inflation and less vulnerable to speculations, which are currently being fueled by the presence of huge quantities of debt instruments in Nigerian and other conventional markets (Shabbir et al., 2016).

However, employees who are knowledgeable about Islamic finance may better serve the industry. The industry in Nigeria requires approximately 11,600 qualified bankers at the end of 2012. For the success of Islamic banking system in Nigeria, there are four levels where human capital capacity building has to take place:

1. The level of the State Bank of Nigeria;
2. The level of the bank owners;
3. The level of entrepreneurs and Islamic bank customers; and
4. The level of the staff of the individual Islamic banking operators.

For the regulatory aspect, it needs to be stressed that under an Islamic system, the role and operations of the apex bank will be multi-dimensional and more complex than the traditional banking system (INCEIF, 2006b) in (Daud *et. al.*, 2011). However, some studies, such as Chapra (2009, p.50) in Daud *et. al.* (2011) made it clear when he submitted that, "All financial institutions and not just the commercial banks need to be properly regulated and supervised so that they remain healthy and do not become a source of systemic risk". Therefore, CBN needs to provide sufficient and comprehensive supervision of the Islamic banks because of its special products, its operation which is devoid of the element of interest, the mandatory deposits and placements which such banks must keep with the CBN for the purpose of liquidity, day-to-day operations and the security reason.

The benefits of Islamic banking in Nigeria are significant and numerous to the extent that the opportunity cannot be neglected. Although, the viability of the system is faced with a lot of challenges and problems, but the benefits and opportunities outweigh these challenges which means that they must be adequately taken care of. As a result, the system will stay and continue to grow. Thus the present study makes an effort to address these issues and challenges (both the identified and other un-identified). Recently, the beauty of Islamic banking realized by the people is its value-proposition and the way in which Islamic finance is done (Shahzad and Rehman, 2015). Islamic finance emphasizes the importance of basic banking and the need to have a clear separation of higher risk-taking activities, such as complex derivatives and structured credit instruments. It also emphasizes a close link between financial transactions and real economic activity. Therefore, it serves the real economy.

3. Methodology

The study employs qualitative research method which consists of personal or face-to-face in-depth-interview with regulatory officers, practitioners and academicians who are directly involved in the operations of Islamic banking system in the two countries, Malaysia and Nigeria, using a written semi-structured interview. Further, the study also employs library work form of documentary review. Electronic recording devices such as audio and video camera are used, and the voices from the recording devices are transcribed. A total number of twenty-two (22) respondents (from Malaysia and

Nigeria) have voluntarily participated in the study. The respondents comprised males and females who are thirty (30) years and above (except one respondent who is between 20-29 years of age). The respondents are with at least first (bachelor) degree level of education (except one respondent with diploma). All respondents are at the management level positions in their respective organizations (except two respondents). In addition, all respondents are Muslims except one who is Christian.

4. Findings of the Study

4.1. Preliminary Findings

From the findings of this study, it is concluded that in terms of basic things, most but not all the situations regarding general regulation and supervision in Nigeria are in line with those of Malaysia. In addition to ten challenges identified by the head of the State bank of Nigeria, the findings of this study reveal that development of Islamic banking system in Nigeria is facing these constraints: 1. lack of government support; 2. misconception about the concept of Islamic banking system, and 3. religion and ethnic sentiments.

The identified challenges and the above three constraints have been hindering the progress and development of Islamic banking system. Although a lot has been done by the State Bank of Nigeria as the regulator according to the findings of the study but the desired results are yet to be seen. The operators are still waiting eagerly for the required and satisfied level of achievements or results from the efforts of CBN in addressing all these challenges. For instance, the responses of some respondents for the study support this point of view.

5. The Way Forward

This section presents recommendations of the study and these recommendations are mostly based on the suggestions made by the respondents of the study and others from the literature reviewed during the study.

1. The findings of this study reveal that there is a need for all the stakeholders and the general public in Nigeria to get a wide exposure about the essence of Islamic banking and on how it can be implemented and operated successfully. Thus, the study calls for a special need to create public awareness and to educate the public, both the regulators and operators should join hands for this project. There are enough evidences from the findings of this study to believe that this project is capable of providing solutions to other challenges without or with minimum efforts and interventions.
2. As lamented by all the operators-respondents the issue of providing Islamic liquidity instruments by the regulators especially Central Bank of Nigeria, DMO, Ministry of finance, for the effective and efficient operation of the industry should be handled as a matter of urgency. This has been the major cause of loss recorded

by Jaiz bank in its financial report of 2012. From Malaysian experience the Central Bank of Malaysia and Ministry of Finance had provided Islamic liquidity instruments for the operation of Islamic banks through the provision of Investment Act 1983. According to one Malaysian respondent, Ismail Mahayudin (respondent R6), for the first three months of the operation of the pioneer bank in Malaysia (Bank Islam), the bank transacted with the Central Bank of Malaysia (BNM)only.

3. It is revealed from the findings of the study that there are no Islamic or shariah compliant instruments for deposits insurance in the country. This issue should be handled together with that of the issue of Islamic liquidity instruments. The concerned regulators should use Malaysian experience as a guide.

4. According to respondent R12 of the study, if a person or nation fails to plan that person or nation has already planned to fail, therefore, the issue of specific master-plan for the development of industry should be handled by both the regulators and operators as one of the most important requirements for the effective and efficient operation of the system.

5. From the findings of the study it is revealed that in general there is no provision for comprehensive documentary exercise like that of Malaysia, this is not peculiar to Islamic banking system but to conventional banking also. Thus, this study hereby recommends that both the regulators and operators should establish a unit in their organization to handle the issue of comprehensive documentary like that of Malaysia.

6. The regulators especially CBN should form a body which will include all the operators in the industry and the regulators well as the Shariah board members at CBN. This body will be like a consultative forum in which all the operators will be able to share their experiences, to table all their challenges, problems, obstacles and discuss with the regulators in order to find the way out. This forum will also give the regulators the chance to rub their mind with the operators on the new updates in the industry.

7. However, CBN requires nominal cash liquidity for the deposit acceptation by Islamic banks until the appropriate time when Islamic liquidity instruments are available for the industry. For instance, Islamic banks in Bangladesh have been allowed to maintain their statutory liquidity requirement (SLR) at 11.5% of the total deposit liabilities while it is frequently fixed and re-fixed around 15 % to 20% for the conventional banks. This discriminating provision has facilitated the Islamic banks to hold more liquid funds for more investment and thereby generate more profit (Abdul Awwal Sarker 2012). This is in line with the suggestion of respondent R17 of the study.

8. From Malaysian experience, both the regulators and operators should foresee staff stealing in the nearest future in the industry so appropriate mechanism to handle the

situation should be developed by the regulators.

9. In the area of Information technology which is a global phenomenon, it could be great and might add value to the name of our country Nigeria if regulators become pacesetters to provide grants and necessary supports for the IT development in the country.

10. The findings of the study reveal that the level of research and development in the industry and generally at the regulator’s and operator’s levels is very low. A nation will not be able to develop itself if the issue of research and development is not handled as a matter of priority. Thus, this study recommends that a department which will be called research and development should be established in all arms of government that have one thing or the other to do with Islamic and conventional banking and financial systems and the activities of this department should be funded adequately. All banks and other financial institutions should be mandated to establish a unit called research and development in their respective organizations. The activities of this department should be designed to follow footsteps of Malaysia and other developed countries like USA, UK, and Japan among others.

11. In general, Nigerians should take this issue of Islamic banking as it is devoid of any sentiment, being religious, tribal, or political.

12. In order to facilitate progress in the industry the regulators, operators, and shariah scholars should be well aware that they have to handle issue of muamalat with an open mind and they should not be restrictive.

13. Ministry of finance and Security Exchange Commission (SEC) and others authorities of financial sector should work together on how to issue supreme/sovereign Islamic bonds (sukuk) for the country. These regulators should also set up a taskforce that will be responsible for promotion and encouragement to consider sukuk issuance as the best alternative to source of financing among state governments, government agencies, and private as well as public corporations.

14. If Nigerian government is serious about infrastructure development, sukuk issuance is capable of providing reliable and best source of fund for capital and infrastructure development in the country. Experiences of Malaysia and UK on Sukuk issuance are enough evidences on this.

15. This is the right time for the regulators to encourage partnership among the regulators, operators, and educational institutions for the establishment of Islamic banking and financial courses and programs in their programs and curriculum. This should be started from certificate, diploma, undergraduate, post-graduate diploma, masters to doctorate programs. Right now the educational institutions will only be able to do this by having a kind of Memorandum of Understanding (MOU) with institutions in a country like Malaysia due to the advanced level of Malaysia plus

the cost, compared to other countries the cost of study in Malaysia is lower. This partnership in the area of education without benefit of doubt will provide the alternative and cheapest way of tackling the issue of shortage of human power in the industry and in the country Nigeria.

16. The government should consider Islamic banking and financial system as a tool for regional competitiveness and this opportunity is not going to last forever. For instance, UK has tried to position itself as the preferred market of Islamic financial system outside Middle East and Asia. Nigeria can also develop its market to become friendly to attract capital and skills for the development of Islamic banking and finance, to make Nigeria a regional hub for sub-Saharan Africa (if not for Africa as a whole) in Islamic banking and finance. According to respondent R17 if the country is able to do this it will benefit the country (Nigeria) a lot with many opportunities.

17. On the issue of taxation the regulator that is Federal Inland Revenue Service (FIRS) which is the taxation authority in the country should provide a leveled playground for Islamic banking operation in the country. FIRS should also provide incentive to the operators and customers which will not only enhance the competitiveness of the operators in the industry but it will also encourage the potential investors both local and foreign to enter the industry.

18. The Nigerian government and regulators should work together to design effective and efficient mechanisms that will attract the foreign and international investors in the industry.

19. For the development of this industry there is a need of political will and participation of government and the individuals in the country. The researcher believes that awareness program will be able to take care of this need. The success of Islamic banking system in Malaysia is mostly traced to the government's will, participation and support.

20. Globally and for both the Islamic and conventional financial system respondent R8 suggested that we should try to use gold as a replacement of US Dollars in order to cushion the instability of inflation in terms of value as a monetary system.

21. The regulators and operators should partner with the research institute and individual researchers in the areas of product development, service quality, customer services and any other issues that have something to do with growth and development of the industry.

22. For proper, effective and efficient growth and development of the industry Nigerian regulators and operators should put the right person in the right place.

23. Ethics, morals and values in Islam should be made mandatory as a course to be attempted by all the regulators' officers (that will be involved in the operation of

the industry) and all the employees of the operators (from the top management officers to the lowest level).

24. The regulators should bear in mind that in terms of regulations and supervisions framework what they have done is just the basic minimum required for the beginning. They should be prepared and ready for the comprehensive effective and efficient framework for the industry.

6. Conclusion

The broad area under which this study falls is area of implementation, in terms of regulation and supervision of Islamic banking system. As Nigeria started the establishment and operations of its Islamic banking system, the analysis of implementation in the area of regulatory and supervisory roles of State Bank of Malaysia and Nigeria would be suitable to serve as a basis. Additionally, the study reveals that the development of Islamic banking system in Nigeria is facing the following constraints: 1) Lack of government support; 2) Misconception about the concept of Islamic banking system; 3) Religion and ethnic sentiments.

The operators are awaiting eagerly for the required and satisfied level of achievements or results from the efforts of CBN in addressing all these challenges. Then, based on the suggestions made by the respondents, the study provides useful suggestions as a way forward. The study tries to address the issue of challenges to Islamic banking system of Nigeria by comparing Islamic banking system of both Malaysia and Nigeria. The in-depth interview conducted by the study confirms the identified challenges and problems for the expansion of Islamic financial institutions in Nigeria through the available literature. Then the study tries to provide useful suggestions on how to address these challenges.

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