Editor's Note

Islamic finance has been a growing industry in international and U.S. financial markets, and there remains significant growth potential going forward. Much of the growth of Islamic finance has been due to innovations made in the design and implementation of Islamic financial products. Over the recent decades, Islamic financial practitioners have designed *Shari'ah* compliant financial products that are also compatible and applicable within the secular, interest-based financial systems, like those in place in the United States. As a result, Islamic financial products have become a viable alternative for use in secular economies, because they co-exist with the economic and legal frameworks in place in Western financial systems.

While Islamic financial product innovations have paved the way for the worldwide use of Islamic finance as a viable way for Islamic investors to interact in the global markets, there still remains challenges in the application of Islamic financial products across different economic, regulatory and tax regimes. Investors choosing to engage in international Islamic financial transactions are naturally concerned about being treated fairly in the international markets, compared with their secular counterparts. There is an incentive to design the most efficient Islamic financial products. In this discussion, we focus on *Shari'ah* compliant financial products in the areas of international investment in U.S. assets, mutual funds, and *sukuk* and discuss some of the remaining issues and challenges in integrating Western and Islamic financial products and markets.

One of the benefits of modern Islamic financial products is that they allow for *Shari'ah* compliant investment in the U.S. asset markets, and the use of *Shari'ah* compliant products to invest in U.S. real estate has grown significantly. A key issue with using Islamic financial products to invest in U.S. real estate is the tax treatment of the transactions. The *istisna'a-ijara* arrangement is the most common Islamic financial product used to facilitate real estate transactions, because *ijara* separates Islamic investors from the debt components that often accompany real estate transactions in the U.S. The components of the lease agreement and their associated tax consequences of the *istisna'a-ijara* agreement are key to the relative efficiency of this Islamic financial product.

In typical real estate transactions arranged as part of *Shari'ah* compliant financing, a pool of investment properties is identified by a bank or other intermediary. Then, the equity portion of the investment consisting of the down payments can be sold as its own fund to foreign Islamic investors. The intermediary and foreign investors in the

fund can then agree to the formation of a Special Purpose Vehicle (SPV) that serves as a separate legal entity from both the intermediary and investment fund. This type of arrangement allows foreign investors to separate themselves from the debt components of the real estate transaction. However, there are some important tax-related consequences.

The U.S. tax code treats investment in assets differently depending on whether the underlying assets are owned or leased by the foreign entity. In the case of real estate investments, there are significant tax advantages to being the owner financed property, because interest costs can be deducted. However, the separation of debt financing that takes place under a *ijara* lease, while making the investment *Shari'ah* compliant, disqualifies it from the tax advantages of owning real property. A similar situation occurs when U.S. capital assets are leased by foreign investors. Similar to the tax treatment benefiting the owners of financed property, "financing leases" afford investors tax benefits in the U.S. On the other hand, leases that are considered "operating leases" are treated more like foreign operations and are thus subject to further taxation.

One of the biggest concerns of foreign investors is the differential tax treatments that are afforded investors in *Shari'ah* compliant financial products, compared with those of the secular market. In a sense, the U.S. tax system is one that benefits the use of interest financing, because interest used in financing real capital, as well as, financial lease payment, have tax deductibility. *Shari'ah* principles however, hold that Islamic investors should abstain in investing in financial arrangements that use interest financing. Thus, there are important tax consequences for Islamic financing arrangement in which U.S. capital investments are purchased using leasing arrangements that are *Shari'ah* compliant.

Another important area in Islamic investing has been the creation of *Shari'ah* compliant mutual funds. Mutual funds have become an important pooling arrangement that have been used worldwide to allow smaller investors to pool resources and gain access to cheaper trading, diversification, and active management. Both secular and *Shari'ah* compliant mutual fund arrangements have been established. The key difference between the two is that *Shari'ah* compliant mutual funds are prohibited from investing in firms that engage in activities that are forbidden by Muslims, such as those dealing in gambling, alcohol, speculation, *etc*. One important role that Islamic mutual funds provide is that they allow Islamic investors access to the U.S. markets. However, investors in Islamic mutual funds still have concerns regarding the regulations governing mutual funds that invest in the U.S. markets.

In general, the regulatory burdens for mutual fund companies are more consistent across conventional and Islamic mutual funds, as opposed to those governing the tax treatment of interest and financial leases. The most prominent regulation in the context of mutual funds is the Investment Company Act of 1940, which requires the registration of mutual fund companies and is primarily concerned with investor protection. This act applies to all investment companies that offer their products for sale within the U.S., regardless of whether they are based in the U.S. or abroad, or whether they engage in *Shari'ah* compliant activities or not. Thus, Islamic mutual funds based abroad that take on U.S. investors are subject to the requirements of the Investment Company Act of 1940, while those investing in U.S. assets, but not held for sale within the U.S. are exempt form the provisions of the Act. The costs of compliance of U.S. regulations on mutual funds are considered by Islamic mutual funds in determining whether to offer their products to investors within the U.S.

The final area of Islamic finance that we discuss is the issuance of *sukuk* financial products. Like those of mutual funds, *sukuk* issuers are concerned about potential regulations that may make the product issuance more expensive. In the U.S., issuers of financial products within the U.S. must comply with the provisions of the Securities Act of 1933. In the case of *sukuk*, as well as other types of securities, there are certain exemptions, or safe harbor exemptions, to the Securities Act of 1933: Regulation S and Regulation 144A. Under Regulation S, issuers of offshore firms that offer products to offshore investors can be granted exemption from the provisions of the Securities Act of 1933. In addition, the Regulation 144A exemption exempts certain types of transactions involving U.S. investors from the provisions of the Securities Act of 1933. Specifically, the rule allows for the sale of investment products, including *sukuk*, to be sold to U.S. investors, provided the transactions are private sales to qualified institutional buyers (QIBs). Additionally, the securities may not be listed on any public exchange in the United States.

There is significant demand for *sukuk* financial products in the international markets, and U.S. investors are often not necessary to generate sufficient demand. Thus, the majority of issuers choose to invoke the Regulation S exemption, which allows them to avoid some of the costs imposed by the Securities Act of 1933. However, Regulation 144A is still a viable option for foreign *sukuk* issuers interested in selling products within the U.S., while still avoiding many regulatory requirements.

The United States is a relatively friendly environment for the expansion of Islamic financial products, because the regulatory and tax systems tend to neither prefer nor punish Islamic financial products over others. The U.S. tax code is structured to favor foreign firms that engage in debt financing and financial leasing by providing

significant tax deductions. These are advantages that, by their *Shari'ah* compliant nature, Islamic financial products cannot use. However, this advantage is not due to Islamic nature of the products, but the economic restrictions of Islam that limit the scope of their contractual commitments. Likewise, Islamic mutual funds and *sukuk* products are treated no differently than other foreign investment arrangements under U.S. law. There are regulatory exemptions that can be granted for both mutual fund and *sukuk* arrangements, as long as they are not held for public sale to U.S investors. Thus, the U.S. regulatory system provides the Islamic financial markets access to the U.S. asset market with relatively low regulatory costs.

The first paper, by Rachdi, examines the relationship between governance and performance in Islamic banks in Malaysia. There has been significant growth in Islamic banking around the world over the past several decades, and it has become a legitimate alternative to more conventional, Western banking institutions. The goal of Islamic banking is to better reconcile economic and religious principles. The development of the Islamic banking system has also brought about the development of regulatory and governance mechanisms aimed at ensuring the viability of stability of Islamic banking. For example, the Islamic Financial Services Board, the National Shari'ah Advisory Council, and the Malaysian Code on Corporate Governance have all been established to guide governance policies and ensure stability in Malaysian Islamic Banks. Many of these organizations and mechanisms were established as a response to the Asian Crisis of 1997 and 1998. The study uses Malaysian banking data from 2000 to 2011 to analyze the relationship between performance and governance. Several statistical methods are used, including fixed and random effects and GMM estimations. In addition, the paper introduces new measures of measuring bank performance, including the profit/loss sharing ratio, performance of zakah ratio, and Islamic income ratio, which represent a unique contribution to the literature.

In the second paper, Jedidia and Hamza examine liquidity risk in the context of the profit and loss sharing systems (PLS) established by the Islamic banking industry. The study examines how PLS intermediation impacts the liquidity and riskiness of the banks' portfolios. The research concludes that the PLS systems exhibit greater long term liquidity risk, and the authors attribute this to the fact that the PLS banks are transforming short-term deposits into longer-term *musharaka* and *mudaraba* products. However, the study also concludes that the nature of the PLS operations make the firm less exposed to risk transformation. The results have important implication with regards to the ongoing liability management systems in place in PLS Islamic banks.

The third paper is by Abdou, Moslem, and Ismal and examines the practice of risk management in Islamic banks in Yemen. The authors utilize a questionnaire to assess risk management practices (RMPs) in Yemen. The survey is divided into two sections. The first entails: understanding risk and risk management, risk identification and analysis, risk monitoring, RMPs, and credit risk analysis. The second section examines: methods of risk identification, risk management, credit risk management, and types of risk. A regression framework is utilized to examine the potential differences between Islamic and conventional banks. The results show that there are significant differences between Islamic and national banks in the following areas: understanding risk management, risk identification and analysis, and credit risk analysis. There are no differences in the following areas: risk management and RMPs. In addition, there are significant differences there are differences in understanding risk and risk management, and risk identification and analysis between the Islamic and foreign banks.

In the fourth paper, Hidayat, Rashid and Nu Htay examine the performance of Islamic banks in GCC countries, and particular attention is paid to the impact of the 2008 financial crisis on the performance of Islamic banks. The authors use Bank scope data from the banking institutions of 23 countries from 2005 to 2010. A panel regression technique is used to examine the determinants of bank performance as well as the impact of the financial crisis on bank performance. The study finds that equity, short-term funding, overhead, expenses, and GDP per capita significantly influence Islamic banks from 2005 to 2010. In addition, it is shown that the financial crisis of 2008 significantly affected the performance of the Islamic banks under study. The study contributes to the literature on the determinants of banking performance and stability.

The fifth paper is by Sain, Rahman and Khanam. This paper attempts to explain the necessity of Islamic Finance and its expansion worldwide as an alternative financial system. The different aspects of Islamic Finance are also carefully discussed. The method employed in this study is a mixture of direct observation from the legal and regulatory perspectives, literature review, and the authors' personal experience and association with this industry. Examining the above, this paper finally discusses the history, development and current issues of Islamic Finance in Australia.

In the sixth paper, Warnida examines the determinants of the Rural Bank of Indonesia's profitability. Recently, the Rural Bank of Indonesia has seen an increase in total assets and total financing. However, this was associated with a decrease in bank profitability. Thus, an analysis of the determinants of bank profitability is important in creating more efficient banking operations. The study analyzes the

determinants of bank profitability in the short and long run using a dynamic error correction model (ECM), and finds that profits are driven by both internal and external factors. Several factors have a negative impact on short and long term profits, however, Mudharabah Time Deposits have the largest negative impact on firm profitability in the short run. In addition, Non Performing Financing is found to have the largest negative effect on firm profitability in the long term.

The seventh paper is by Huda et al. and examines the problems surrounding zakah in Indonesia and proposes solutions to those problems. The authors construct a model, quantify the model, and then analyze the results. The results identify the main problems of zakah in Indonesia. The study finds four problems with regulation, six problems caused by OPZ, and four problems with stemming from *muzakki* and *mustahik*. As a way of solving these problems, the authors identify the main problems. In terms of regulation, the main focus should be to certify *amil* and standardize OPZ. In terms of OPZ, efforts should be made to improve transparency and improve the effectiveness of the program's utilization. Finally, solutions for muzakki and mustahik are also discussed.

In the eighth paper, Ahamed and Islam analyze the issue of employment satisfaction and involvement in commercial banks in Bangladesh. Job involvement and satisfaction is an important part of maximizing productivity within an organization, including commercial banks. The study used secondary published data in addition to 385 responses from employees of commercial banks in Bangladesh. The study finds that commercial banks in Bangladesh are very satisfied with their jobs and are also very involved with their jobs as well. In addition, the study concludes that those employees who are not as involved with their jobs are so because they do not feel like their job should be the most important thing in their life.

The ninth paper is by Shah and Hussain and it emphasizes the importance of the growth and development of Islamic finance industry in minority Muslim countries like Sri Lanka and India. The Islamic finance industry has been growing rapidly throughout the globe since its beginnings in the late 1960s and early 1970s. The appeal of Islamic finance and financial products is that they re-align economic and religious motives and allow for Muslims to interact with each other and with Western economies, while still remaining faithful to the tenants of Islam. The economies in the Middle East and the West have engaged in and seen the benefits of Islamic economics and finance. In addition, academics from around the world have also studied its motivations, implementation and impact. However, there is still little

literature that analyses the Islamic financial industry in countries with a minority Muslim population. This paper aims to address this issue by examining the Islamic business sector in Sri Lanka and India. The implications in these countries are significant, because, even though they have Muslim minorities, the total amount of Muslims is still quite large in these areas.

In the tenth paper, Chazi, Rao and Syed examine the potential role of Islamic sukuk products in solving the infrastructure problem seen in most African countries. The lack of viable infrastructure in many African countries is a problem that keeps the continent from advancing economically, which has kept the African people in poverty and in poor health. This disparity has existed for decades, despite the fact that these countries often contain valuable natural resources. This paper suggests that the Islamic sukuk arrangement may provide a solution to the problem of infrastructure funding in these countries. The paper presents alternative sukuk structures that may specifically be designed for the purpose of infrastructure financing. This type of financing may help lead to a more developed infrastructure in Africa, which can help to drive economic activity and improve the quality of life in African countries.

I hope you will enjoy reading this issue of the Journal.

M. Kabir Hassan, Ph.D.

Professor of Finance and

Hibernia Professor of Economics and Finance

New Orleans and Philadelphia, USA

Reference:

Blake Goud and M. Kabir Hassan (2011), Islamic Finance in the United States, Chapter 14 in Islamic Capital Markets: Products and Strategies, edited by M. Kabir Hassan and Michael Mahlknecht. John Wiley and Sons, 2011, London, UK.