The revolution in the global Islamic finance ecosystem: the need for governance, standardization and regulatory support

Irshad Mahmood | 3-4 November 2019
# Agenda

Topics to be covered today

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<td>Characterization of Islamic finance transactions</td>
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</table>
1. Introduction

Presenter’s background:

✓ **Over 25 years of professional experience** specializing in financial services including banking, Islamic banking, private equity and real estate funds, insurance and capital markets

✓ **Significant industry experience** having led the finance function of Samba Financial Group in Saudi Arabia and Ufone (a subsidiary of Etisilat)

✓ Responsible for assisting the audit teams and clients across the Middle East region with **technical issues related to IFRS and Islamic finance**

✓ **Board Member** of the Accounting Board of the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI)

✓ **Member** of the Technical Accounting and Interpretation Committee (TAIC) at the AAOIFI

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✓ **Over 20 years of professional experience** specializing in financial services including banking, Islamic finance, asset management, telecom, insurance and capital markets

✓ **Head of Department of Professional Practice and IFRS and AAOIFI** technical partner for KPMG in the region and part of KPMG Global International Standards Group topic team on Business Combinations and Consolidation.

✓ Responsible for assisting the audit teams and clients across the Middle East region with **technical issues related to IFRS and Islamic finance**

✓ **Member** of the Technical Accounting and Interpretation Committee (TAIC) at the AAOIFI

✓ **Project manager** leading the development of FAS 25 and FAS 26 for AAOIFI and part of team supporting industry standard Wakala contracts developed by IIFM.
2. Aim of AAOIFI standards

Accounting and auditing, governance and ethics

- **Accounting and Auditing standards**
  - Provide guidance on accounting treatment for specific Islamic finance products and mechanisms
  - Provide guidance on presentation of financial statements for Islamic financial institutions (IFIs)
  - Provide guidance on external auditing of IFIs

- **Governance standards**
  - Provide guidance on Shari’ah compliance and supervision framework and processes for IFIs

- **Ethics standards**
  - Provide code of ethics for accountants, auditors, and employees of IFIs
3. Perceived gaps in FAS

What are the perceived gaps in FAS compared to other global acceptable accounting practices?

One of the major challenges facing IFIs lies in the preparation of the financial statements under different accounting standards and which may lead to problems of comparability, reliability and compliance level measurement. This has resulted in a heated debate among scholars which has hitherto translated to the evolving existing literature surrounding the interpretation of the level of compliance with the Islamic accounting standards.

Development

- IFRS are developed and continuously being developed.
- Unfortunate fact that there is no significant effort on standardization of accounting principles in Islam. AAOIFI standards cater to the IFIs only, and not all the businesses in general.

Information Needs

Information needs of Muslim or Shari'ah compliant stakeholders differ significantly from a conventional stakeholder. This is due to its information needs for computation of Zakat, profit and loss distribution, screening of permissible investments and laws of inheritance.

Accounting Principles

Differences in accounting principles arising because of rejection of conventional financial system and its transactions by the Islamic economic system or rather the Islamic financial system, to be specific.
3. Perceived gaps in FAS (continued)

**Objectives and focus**

<table>
<thead>
<tr>
<th>Conventional accounting</th>
<th>Islamic accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Conventional accounting aims to permit informed decisions by information users, whose ultimate purpose is, to efficiently allocate scarce resources available to the best efficient and profitable manner.</td>
<td>• Islamic accounting abides by the principles of Shari'ah and rules in their dealings and to assess whether the objectives of the organization are being met.</td>
</tr>
<tr>
<td>• Conventional accounting concentrates on the information identifying economic activities and transactions.</td>
<td>• Islamic accounting also identifies and deals with certain socio-economic factors, religious activities and transactions.</td>
</tr>
</tbody>
</table>
3. Perceived gaps in FAS (continued)

✓ Present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

✓ Islamic accounting additionally aims to serve a wider range of stakeholders, in a wider array of information needs.
3. Perceived gaps in FAS (continued)

**Time value of money**

There is a view that for the purpose of better accounting, comparability and transparency, the concept of time value of money should be applied in accounting for Islamic finance.

On the other hand, if time value of money concept is accepted in accounting for Islamic finance then Islamic banking may no longer be termed as Islamic in its essence.

In an interest free economic system, the discount rate should always be zero and hence the present value of receivables should be equivalent to their par value.
4. Known differences from IFRS

Major differences seen in practice

1. Equity of IAH and Attribution of profits and losses
2. Linked contracts
3. Recycling and OCI
4. Transition guidance
5. Revenue recognition
6. PER and IRR
7. Leasing and reserves (FAS 30)
8. Variability and consolidation
9. Foreign Exchange accounting
10. Investment property
11. Wakala (agency arrangements)
Emerging areas which require new guidance

1. Presentation and disclosures
2. Sukuk
3. Hedging and Derivatives
4. Takaful and Retakaful
5. Revenue recognition
6. Growing/Diminishing Musharaka
7. Micro-finance
8. Tawaruq
9. Foreign Exchange accounting
10. Restructured contracts
11. Dealing in own equity investments
6. The case for separate characterization of Islamic finance transactions

➢ Accounting must reflect the transactions in their reality and in the right sequencing.

➢ The risk profiles of Islamic finance instruments:
  - are different from conventional transactions; and
  - change with the transaction sequencing.

➢ Most of the recognition and de-recognition principles for assets and liabilities are similar to those of IFRS.

➢ If a transaction is Shari’ah compliant it would be meeting most of the definitions and requirements of IFRS for accounting for assets and liabilities in different stages of a transaction.

➢ Adverse scenarios: most of the Islamic finance transactions would prove to be different from conventional in the adverse scenarios because of different risks and rewards structures on assets and investments. Accordingly, they need separate accounting.
Questions?
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Islamic Crowd Funding: Opportunities and Challenges

Faheem Ahmed
President– Strategic Planning and Global Relationships
Islamic International Rating Agency – Bahrain

November 3, 2019
Crowd Funding

➢ The concept of ‘soliciting capital directly from the investors’ is not new;

➢ Although remained unregulated till The Great Depression, the practice dates back to the 18th century;

➢ Regulatory Reforms of 1930s restricted P2P investments and lending;

➢ Crowd funding revived with the recent advancements in technology and enabling regulatory environment post Global Financial Crisis of 2008;

➢ Crowd funding reportedly achieving triple-digit growth in the last decade with UK, China and US in the lead;

➢ Most activity being witnessed in debt-financing to individuals and SMEs;

Top 5 Crowd funding Platforms

1. Kickstarter.
2. Indiegogo.
3. Patreon.
4. GoFundMe.
5. Crowdrise.
With the presence of regulatory obstacles and inherent riskiness, equity-based crowd funding remains lackluster.

### Alternative Finance in the UK, the EU and North America (NA), 2015 [in million]

<table>
<thead>
<tr>
<th>Country/Region</th>
<th>Loan-based crowdfunding</th>
<th>Investment-based crowdfunding</th>
<th>Total</th>
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<tbody>
<tr>
<td></td>
<td>P2P business lending</td>
<td>P2P consumer lending</td>
<td></td>
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<tr>
<td>UK [GBP]</td>
<td>£881</td>
<td>£609</td>
<td>£3,116</td>
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<tr>
<td></td>
<td>28%</td>
<td>20%</td>
<td></td>
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<tr>
<td>EU [EUR]</td>
<td>€1,182</td>
<td>€1,330</td>
<td>€3,508</td>
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<tr>
<td></td>
<td>34%</td>
<td>38%</td>
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<tr>
<td>NA [USD]</td>
<td>$2,620</td>
<td>$783</td>
<td>$31,132</td>
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<td>8%</td>
<td>3%</td>
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Source: Islamic Financial Services Industry Stability Report, 2017 by IFSB
Shari’a Principles & Crowd Funding

➢ Direct P2P financial activity allows greater communication among parties and higher trust and transparency encouraged in Shari’a principles;

➢ Social solidarity dimension of crowd funding that enables regular and direct interaction between parties also contributes towards reduction in transaction cost;

➢ With regulatory initiatives by various Islamic countries like Malaysia, Turkey, Morocco, Bahrain etc. and formation of Islamic FinTech Alliance, Islamic crowd funding is gaining grounds;

➢ IFSB’s research indicates that of 80 originating from OIC member states:
   ➢ the number of non-charity based platforms that explicitly refer to Shari’a is very small;
   ➢ A very small number of platforms could be termed as ‘active’..
Regulating Islamic Crowd Funding Market

- Major areas of consideration while regulating Islamic crowd funding markets:
  - Shari’a compliance confirmation;
  - Risk assessment of investment seekers and the transaction;
  - Determination of risk profiles of funding providers & seekers;
  - Nature of contracts drawn with clear assumption of liabilities, guidelines on over-/under-subscriptions and legal recourse;
  - Disclosure guidelines for local and cross-border seekers;
  - Mechanisms for post-investment surveillance throughout the life of the transaction;
  - Provisions for emergency exit and nature of compensations in cases of contractual breaches or technology failures;
  - In addition to determining obligations of CF platforms, considering engagement of qualified 3rd parties where required; Examples could be Governance, Social and Environmental Evaluators.
THANK YOU
Islamic Crowdfunding Opportunities

ETHIS GLOBAL

Q4 2019
The Crowdfunding (CF) Opportunity

An emerging fintech model - a marketplace for funds.

Platforms can raise funds from *almost any* source and match them to *almost any* project.

Funds flow directly to the real economy.
The crowd provides term financing to projects, companies or individuals, typically structured as debt-financing with interest.

Islamic structures earn income from profit-sharing, rental and trade.

Large growth in these verticals: SMEs, Property and Consumer loans.

The crowd provides investment for equity in private companies and SPVs, typically ordinary or preference shares.

Shariah screening focuses on the issuer’s business and internal finances.

Large growth in these verticals: SMEs, Property and Startups.
Growth of P2P Crowdfunding

Global P2P financing issuance, USD (bil)

- 2016
- 2017
- 2018
- 2019

Indonesia total P2P financing issuance, USD (bil)

- December 2016
- December 2017
- January 2019

Source: Morgan Stanley
Source: OJK, Indonesian financial services authority
Our Problems

Direct investments and charity in emerging nations is broken.

- Incumbent financial institutions serve limited preferred segments, and have low social impact
- Local capital flows are poorly organised
- Global flows lack intelligence and facilitation
ETHIS believes that Crowdfunding is the FUTURE of Islamic Finance.
The Difference

Money movement driven by the people.

Mechanisms to enforce transparency, screening and accountability.

Increases efficiency of existing flows and activates new flows.
Key Opportunities and Applications

Great potential for Zakat, Waqf and Sadaqah.

Funding for the underserved. An opportunity for everyone.

Current growth is in consumer, SME/ MSME, Property.
Crowd - Investors, Backers, Donors

- Low minimums, wide variety
- Transparent campaigns with updates
- Ease of use and cross-border
Fundraisers

New, faster and more flexible avenue

Public awareness and market validation

Leverage on communities
Excellence
Transparency
Honesty
Integrity
Sincerity
Mission
Lead crowdfunding for impactful circulation of capital globally, based on universal ethical principles.

Vision
Create crowdfunding unicorns in the Ethis group by 2023.
PoC: Ethis Indonesia
Affordable housing project supported by a government program.

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
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</table>
| 2015 | Investment Club  
Club Ethis Islamic Investment SMEs, Startups and Property |
| 2016 | Pivot  
EthisCrowd.com Property CF Social Housing in Indonesia |
| 2017 | Pilots  
Processing license in Malaysia  
Piloted various models |
| 2018 | Tightening Dealflow  
Fund one campaign at a time  
Processing license in Indonesia |
| 2019 | Scaling Up  
Fund multiple campaigns  
Licenses obtained |

- 3,000 Investment Transactions
- $43m Projects Value
- 8,000 Affordable Houses

PoC: Ethis Indonesia
Affordable housing project supported by a government program.
The Ethis community includes:
- Millennials and young professionals
- Islamic finance practitioners
- Foundations and community groups
- High-networth individuals
- Venture and early-stage investors
- Impact investors

Our crowd of 28,000 has made 1,300 investments.

98% are first-time investors in Indonesia.
Global Expansion Pillars

1. Scale-up in large emerging markets
   Indonesia is our main market. It is one of the most attractive emerging markets in the world and has a booming crowdfunding sector.

2. Branches in major Islamic finance hubs
   We are licensed in Kuala Lumpur and obtained an approval in Dubai.

3. Enter new regions in the Muslim world
   Obtain licenses to cover MENA and Central Asia.
ETHIS VENTURES RECEIVES MALAYSIA'S FIRST ISLAMIC ECF LICENSE

By Digital News Asia May 21, 2019

- ECF is a true Musharakah or Mudarabah relationship with shared risk and reward
- Plans to attract promising Islamic economy startups to setup and raise funds in Malaysia

DLD launches 4 new investment products in Dubai's real estate market

Tuesday, July 02, 2019

Dubai Land Department (DLD) announced four new Real Estate Investment Opportunities (REIOs) conference held yesterday. The new initiative targets all economic sectors.

Before the launch of the project, a feasibility study was conducted, and the most prominent international experts and global practices were reviewed, and an action plan was formulated to follow up and develop the project. The four REIOs include several important investment products, notably the collective real estate investment products, procedures to register units owned by a single person, and investment products

Ethis Group of Crowdfunding Platforms to Participate in Dubai Property Development

July 5, 2019 @ 6:14 am by JD Abbas

Listen to this article

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TogetWidth its attrat
Awards & Accolades

GIFA Award for Best Islamic Crowdfunding Platform 2016

Islamic Economy Award 2016 from the Crown Prince of Dubai

World Islamic Fintech Awards 2018 for Best Islamic Peer to Peer Finance Platform (Ethis) & Best Social Impact Islamic Fintech Platform (Global Sadaqah)
Ethis won the coveted US$100,000 ‘Innovation for Impact’ grant and will be featured in the Dubai Expo 2020.
Datuk Mohd Radzif Yunus, Founder/ Chairman
Datuk is a proven leader with a demonstrated track record of transforming large business groups and organisations to achieve successful turnarounds. A firm believer in "Doing well to be able to do more good", Datuk sits on various boards of listed companies across healthcare, property and education. Datuk provides leadership to the dynamic founding duo of Umar and Ronald.

Umar Munshi, Founder/ CEO
A social entrepreneur since 18, with experiences in health-tech, Islamic finance and education that brought him from Singapore to Saudi, a long stint in Indonesia in a partnership with Ronald, and now Kuala Lumpur. Umar is well-connected to the fintech world, as the Chairman of the Islamic Fintech Alliance and a committee member of Fintech Association Malaysia.

Ronald Wijaya, Founder/ COO
A social entrepreneur since partnering with Umar a decade ago, Ronald has wide experiences as an entrepreneur and business consultant in various sectors across Indonesia including health-tech, trading, property and manufacturing. Ronald is the president of the Association of Shariah Fintech Indonesia (AFSI), the largest such group globally with >50 startup founders.

Ethis Global Founders
<table>
<thead>
<tr>
<th>Name</th>
<th>Title/Background</th>
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<tbody>
<tr>
<td>Azizuddin Aj</td>
<td>CEO/Founder of Finocracy, 21 years in tech, strong ecosystem knowledge and</td>
</tr>
<tr>
<td></td>
<td>relationships</td>
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<tr>
<td>Md Raafi Hossain</td>
<td>Founder of Finocracy, develops fintech in partnership with corporates,</td>
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<td>governments, and multilaterals.</td>
</tr>
<tr>
<td>Rehan Noor Pathan</td>
<td>Over 2 decades of experience building institutional sales businesses for global</td>
</tr>
<tr>
<td></td>
<td>institutions and Family Office investors</td>
</tr>
<tr>
<td>Daud (David) Vicary</td>
<td>Global Islamic Finance leader, advisor to various corporates, governments and</td>
</tr>
<tr>
<td></td>
<td>multilaterals</td>
</tr>
<tr>
<td>Dr Shamsiah A K</td>
<td>Waqf and Zakat specialist, former regulator turned consultant and entrepreneur</td>
</tr>
<tr>
<td>Ridzuan Aziz</td>
<td>Successful exits.</td>
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<td></td>
<td>President of Fintech Malaysia. Former regulator turned consultant and entrepreneur</td>
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</tbody>
</table>
Current Capability: Web Platform
Web presence (SEO), user-interface, clarity of content

Version 2
API-based Web App
Robust, seamless and automated internal operations and integration with external vendors and partners

Version 3
Smart Contracts and Tokenised Securities
Seamless global transfers, secondary market, end-to-end automation, robust data capabilities and robo-advisory
Ethis is Ethical Crowdfunding. Let's change the world together. Make a profit. Make a difference.

Our platforms feature exciting and sustainable campaigns. You are the ethical fundraisers. When good intentions converge, we inspire change in the world. Impact investment. Participatory Project Financing. Effective Charity. We are Ethis.

View our Platforms
Invest, Donate or Raise Funds. Participate in our global movement for change

Charity Crowdfunding Around the World
Global platform for effective charity and Islamic social finance. Give Sadaqah, Zakat and Waqf online to credible charities and social enterprises alongside corporates and high-net-worth individuals.

Property Crowdfunding in Indonesia
Award-winning impact investment platform. Make healthy profits while building homes for low-income families. Investors from 65 countries have built more than 8,000 affordable houses since 2016. Property Crowdfunding in Indonesia

Property Crowdfunding in Dubai
Dubai's first and only investment platform in under-construction projects. Build a portfolio in the property capital of the Middle-east and make profits like a property developer with asset-backed investments.

Equity Crowdfunding in Malaysia
Participate in equity project financing by investing directly into companies and SPVs. Almost anyone can now access institutional-grade private equity deals, fractional property investment and Waqf projects.

**SHARI’AH DECISION MAKING PROCESS**

Dr Ahcene Lahsasna
CEO. Salihin Shariah Advisory (Malaysia)
Dimensions of Shari’ah decision making in Islamic finance

- Shari’ah decision making is a process/ an exercise undertaken by the Qualified Islamic finance scholars or professionals in order to provide a Shari’ah position that could be in a form of Shari’ah Ruling on operations matter or management decision to resolve a Shari’ah compliant matter and to provide a solution for existing or future issues faced by the IFI within the Shari’ah rules, values and principles.
The Shari’ah decision making of Shari’ah board and senior management in the IFI

The difference between Shari’ah decision making of Shari’ah board and senior management in the IFI;
• The Shari’ah board will form a fatwa or Shari’ah ruling related to Shari’ah matters,
• The decision of the senior management would be in a form of resolution of decision that is operational and management in nature but has Shari’ah implications.
• Both decision have Shari’ah implications by end result
• Shari’ah board decision covers on Shari’ah matter
• Decision of senior management encompasses the operations and management matters.

• The key point here is that the management and board should not discount the importance of Shari’ah in their resolution, it should be integrated in their thinking and decision-making process.
The structured methodology & process of obtaining Shari’ah ruling/ resolutions in Islamic finance matters

• The Shari’ah board of the Islamic Financial Institutions in issuing resolutions or Shari’ah rules related to Islamic finance matters follow a sound structured and process to ensure consistency and robustness of the decision making; the methodology employed is briefly described as follows:
The *Shari’ah* decision making should reflect *Maqasid al Shari’ah*, where the outcome of the decision must be in accordance with the objective of *Shari’ah*.
Sustainability is one of the most significant trends in the current financial markets:

1. Whether in the form of investors’ desire for sustainable responsible investing (SRI),
2. or corporate management’s focus on corporate social responsibility (CSR),

The content, focusing on sustainability and ESG (environmental, social and governance) issues, is the same.
Sustainable finance refers to any form of financial service integrating environmental, social and governance (ESG) criteria into the business or investment decisions for the lasting benefit of both clients and society at large.

**Environment**
- Humans are social when they live collectively in interacting populations, whether they are aware of it, and whether the interaction is voluntary or involuntary.

**Social**
- Environment is everything that is around us. It can be living or non-living things.

**Governance**
- Governance is all of the processes of governing. It is the way the rules, norms and actions are structured, sustained, regulated and held accountable.
<table>
<thead>
<tr>
<th><strong>ENVIRONMENTAL</strong> (&quot;E&quot;)</th>
<th><strong>SOCIAL</strong> (&quot;S&quot;)</th>
<th><strong>GOVERNANCE</strong> (&quot;G&quot;)</th>
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<tbody>
<tr>
<td>Biodiversity/land use</td>
<td>Community relations</td>
<td>Accountability</td>
</tr>
<tr>
<td>Carbon emissions</td>
<td>Controversial business</td>
<td>Anti-takeover measures</td>
</tr>
<tr>
<td>Climate change risks</td>
<td>Customer relations/product</td>
<td>Board structure/size</td>
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<tr>
<td>Energy usage</td>
<td>Diversity issues</td>
<td>Bribery and corruption</td>
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<tr>
<td>Raw material sourcing</td>
<td>Employee relations</td>
<td>CEO duality</td>
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<tr>
<td>Regulatory/legal risks</td>
<td>Health and safety</td>
<td>Executive compensation schemes</td>
</tr>
<tr>
<td>Supply chain management</td>
<td>Human capital management</td>
<td>Ownership structure</td>
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<tr>
<td>Waste and recycling</td>
<td>Human rights</td>
<td>Shareholder rights</td>
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<tr>
<td>Water management</td>
<td>Responsible marketing and R&amp;D</td>
<td>Transparency</td>
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<tr>
<td>Weather events</td>
<td>Union relationships</td>
<td>Voting procedures</td>
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</tbody>
</table>
Consideration of the criteria of green technology and sustainable development in offering products and services
An intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, without compromising the financial returns to shareholders.
## Criteria of sustainability for financing decision making

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<tbody>
<tr>
<td></td>
<td>CSR Policies, Procedures, Departments</td>
<td>Financial Inclusion, Micro and SME Finance</td>
<td>Non Profit Financing</td>
<td>Philanthropic and Social Programmes</td>
<td>Impact of the Environmental and Social Activities</td>
<td>Assessing, Screening of Environmental and Social Risks</td>
<td>Staff Competency and Customer Relations</td>
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The above process is after:

* Compliance with *Shari’ah* requirements
* Compliance with Legal requirement
* Compliance with other requirements where applicable (depending on each country)
Criteria of sustainability in investment decision making

Suggesting Green category for Shariah compliance investment

**SC Methodology for Shariah compliance stock screening**

**Green Shariah compliance category stock**

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**Examples**

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<td><strong>Non Profit Financing</strong></td>
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<td><strong>Philanthropic and Social Programmes</strong></td>
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<td><strong>Impact of the Environmental and Social Activities</strong></td>
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<td><strong>Assessing, Screening of Environmental and Social Risks</strong></td>
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<td><strong>Other Elements of ESG, SDG &amp; VBI</strong></td>
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</tr>
</tbody>
</table>

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Sustainable financing
Independence and conflict of interest issue

Conflict of interest could represent an issue if it is not well addressed in the context of Shari’ah decision making process, among the vital aspects that should be considered in the conflict of interest is as follows:

• Disclosure requirement of potential conflict of interest such as having relationship or interest in the subject matter of the decision.
• It could be the person who is making decision is a Shari’ah advisor of that particular company, he or she could be one of the shareholders of the company, he or she could have relatives working in the subject company.
Risks Mitigation in *Shari’ah* decision making

- *Shari’ah* non-compliance risk or otherwise, is part of the possible risks that could be associated with the *Shari’ah* decision making.
- *Shari’ah* non-compliance risk may have a significant impact and implication on the profitability of the IFI and its branding, image as well as reputation.
- Hence, *Shari’ah* non-compliance risk must be mitigated in *Shari’ah* decision making.
The role of good governance practices in avoiding hidden traps

- Governance aspect is very important in Shari’ah decision making, it determine the appropriate process that should be followed, to determine the accountability, responsibility and scope of agreed upon duties to discharge the obligations.
- It should be clearly incorporated in the SOP and corporate governance framework of IFI.
- Proper illustration on the line of reporting
- Proper illustration on the delegation of power
The importance of critical *Shari’ah* analysis

- *Shari’ah* analysis is part and parcel of *Shari’ah* decision making
- An appropriate *Shari’ah* analysis must take place to ensure very effective and efficient decisions and resolutions.
- Brief descriptions of the different dimensions of the *Shari’ah* analysis are as follows:
A. Fundamental Aspects of Shari'ah analysis in Shari'ah decision making
   • Understanding the composition of Islamic finance industry
   • Understanding Shari'ah principles and values in Islamic economics and finance
   • Connecting the dots between the Shari'ah contracts and the enhanced Shari'ah contracts
   • Appreciate the enhanced of Shari'ah concepts and terms in Islamic finance

B. Framework of Shari’ah analysis in Shari’ah decision making
   • Product descriptions and features
   • Legal and Regulatory requirements
   • Shari’ah compatibility

C. Practical and technical knowledge in Shari’ah analysis in Shari’ah decision making. Understand:
   • The nature of Islamic finance business model
   • Islamic finance versus conventional finance
   • Prohibited elements and activities in Islamic financial system
   • Business ethics, values, principles and norms of Islamic Finance
   • The different Islamic finance portfolios
   • Understanding the scope of the proposed product and its niche market
   • Selection and mapping of the Shari’ah contracts
   • Differentiate exchange contracts and voluntary contracts
   • Ensure the compliance of the Shari’ah contracts
   • Careful design of the combination of contracts
   • Observation of the sequence of the execution of contracts

D. Parties involved in Shari’ah decision making at approval stage
   • Owner of the product
   • Shari’ah department
   • Legal department
   • Risk management
   • Shari’ah board
   • Risk management
THANK YOU
ahcene@salihin.com.my
AAOIFI’s Governance Standard on Shari’ah Compliance & Fiduciary Rating for IFIs & Islamic International Rating Agency (“IIRA”) Rating Methodology
- IIRA was set up as an infrastructure institution for Islamic Finance in 2002
- Islamic Development Bank was the founder shareholder
- Two key objectives were and are relevant
  - Growth of national and international sukuk markets through ratings in Islamic countries where rating culture is not well developed
  - Providing a value added service to Islamic investing by formalizing a view on Shari’ah compliance
IIRA provides ratings for all types of issuers and issues

- Shari’ah Compliance and Fiduciary Rating
- Sovereign Ratings
- Issuer Ratings
- Sukuk Ratings
- Takaful Financial Strength and Fiduciary Ratings
- Participation Banks Fiduciary Ratings
- Governance Ratings
- Waqf Assessment (Development in progress)
- Collective Investment Scheme (CIS) Ratings

- Financial Data Portal (available through Subscription)
- Rating and training workshops
IIRA’s Presence in Islamic Markets

**GCC**
- Bahrain
- Kingdom of Saudi Arabia
- United Arab Emirates
- Oman

**Levant**
- Egypt
- Jordan
- Lebanon
- Syria
- Turkey

**Africa**
- Sudan
- Tunisia
- South Africa
- Algeria
- Nigeria

**South & South East Asia**
- Malaysia
- Pakistan
IIRA – Primary Objectives

- Be an alternate voice in international ratings
- Customized approach to rating Islamic Financial Institutions
- Facilitate Development of Sukuk markets through National Scale Ratings
- Facilitating Cross-border Transactions
- Form local base in key OIC member economies
- Wide coverage of Sovereign Ratings in OIC Countries
IIRA provides ratings for all types of issuers and issues through a value added methodology that incorporates the element of Shari’ah governance in all of its ratings through its “Fiduciary Ratings”

IIRA’s Fiduciary Ratings appeal to the diverse needs of investors, with greater information regarding institutional financial strength, in addition to governance infrastructure, while giving specific coverage to Shari’ah governance.
How are Fiduciary Ratings differentiated from conventional ratings?

- Two-dimensional assessment – recognizes the mutually dependent nature of credit & Fiduciary risks in an IFI
  - Poorly governed institutions – may be more susceptible to the risk of credit failure
  - Credit event could be triggered by perception regarding Shari’ah Governance

- Credit ratings may be faced with downward pressure on account of developments in terms of fiduciary capacity
- Market participants recognize the need of investors to discern the level of compliance with generally accepted standards

- Hence a standard focused on providing such information

- Encapsulates all areas of coverage laid out in GSIFI 10 to be finalized shortly

- Comprehensive guidance for best practices, resulting in a continuously evolving framework of governance for Islamic financial institutions.
The Standard and methodology envisages the institutionalization of a system of review of IFIs’ adherance to Shari’ah related guidance and standards.

Issues an independent opinion

The final output in the form of an Alpha-numeric symbol is indicative of the rank order classification of a financial institution in terms of compliance of and fulfillment of the Fiduciary responsibilities of Shari’ah based investing.
The fundamental objective of ratings is to evaluate the process of compliance to a pronouncement, as put in place, more than evaluate the ‘correctness’ of the underlying structure itself.

IIRA further evaluates Islamic financial services or products of an institution against a ‘hierarchy of standards of Compliance’, being ‘international’, ‘local’ or ‘institution’ level

- International best practices
- Country level guidance
- Institutional approvals or guidance
Best practices remain universal; ratings will be benchmarked to international best practices (save in areas where regulations or commercial law bars an institution from instituting such practices).

In terms of product structure and design, where permitted practices are notably weaker than internationally relevant guidance, ratings may be relatively lower rating than those of an institution which follows international best practices.

Rating evaluation is conducted annually to capture both positive and adverse developments on a timely basis.
Reflects a combined assessment of an IFI’s relative state of compliance, duly reflected on a rating scale, with standards, regulations and best practices (collectively called benchmarked practices) with regard to

(A) Compliance with Shari’ah principles and rules
(B) Shari’ah Governance Framework
(C) Corporate Governance Practices
(D) Transparency and Disclosures
(E) Ethics and Values
(F) Fiduciary Responsibility and Performance.
Compliance with Shari’ah principles and rules-

- A.1 Compliance with Shari’ah principles and rules in terms of product structure,
- A.2 Adherence to approved structures and policies as also evidenced in the generation of non-halal income as a consequence of inconsistent implementation of A.1 above,
- A.3 Asset Manager Quality, i.e. quality of business generated and avoidance of unnecessary risk backed by a sound, business screening process, reflected in risks and return characteristics vis-à-vis peers.

Shari’ah Governance Framework

- B.1 Empowerment, Independence, Competence and Integrity of Providers of Shari’ah Guidance through Shari’ah Supervisory Board and Management engaged in the enabling of Shari’ah compliant finance,
- B.2 Organization wide acceptance and respect for faith based finance,
- B.3 System of checks and balances through internal and external audit, enabling the roll out of Shari’ah principles in business.
Corporate Governance framework

- C.1 Empowerment, Independence, Competence and Integrity of Leadership to enable a system for protection of rights of stakeholders including unrepresented shareholders, and most significantly investment account holders
- C.2 System of Internal Control enabling A.3 and C.1 above

Transparency and disclosure

- D.1 Disclosure of practices and performance through published and web based media,
- D.2 Investor engagement and in particular communication with takaful participants in Takaful firms and investment account holders in Islamic banks, by recognizing the difference in nature of claim of investment account holders in IFIs vis-à-vis that of depositors in conventional banks.
Ethics and Values

- E.1 A code of ethics and values should be adopted at all levels within the organization,
- E.2 An appreciation of environmental and social ecosystems as a tenet of faith based investing should be incorporated in investment screening processes,
- E.3 Entity level adoption of practices that respect the environment and social causes.

Fiduciary Responsibility and Performance

- F.1 Methods employed for distributing returns,
- F.2 Comparison of returns or losses transferred to investors.
AAA (SCFR) – conforms to the highest level of standards in terms of fulfilling fiduciary obligations of Shari’ah compliant Finance

AA (SCFR) - Conforms to very high level of standards in terms of fulfilling fiduciary obligations of Shari’ah compliant Finance

A (SCFR) – conforms to high level of standards in terms of fulfilling fiduciary obligations of Shari’ah compliant Finance

BBB (SCFR) – conforms moderately to standards in terms of fulfilling fiduciary obligations of Shari’ah compliant Finance and has few weaknesses in some areas of Shari’ah compliant Finance

BB (SCFR) – conforms to satisfactory level of standards of Shari’ah requirements and has notable weaknesses in some areas of Shari’ah compliant Finance.

B (SCFR)– Does not conform adequately to Shari’ah requirements and has notable weaknesses in several areas of Shari’ah compliant Finance.
On the panel of approved rating agencies of IDB

Recognized as an External Credit Assessment Institution (ECAI) by:

- Central Bank of Bahrain (CBB)
- Central Bank of Jordan (CBJ)
- Banking Regulation & Supervisory Agency (BRSA), Turkey
- Central Bank of Sudan (CBoS)

Recognized as an External Credit Rating Agency (ECRA)

- Astana Financial Services Authority (AFSA), Kazakhstan
- The Securities and Exchange Commission of Pakistan (SECP)

IIRA is also an approved rating agency by the National Insurance Regulatory Authority, Sudan

IIRA is also licensed to operate as a rating agency in Sultanate of Oman
Rating Committee consists of

- Core members
- Shari’a experts.

All members are completely independent with no conflict of interest

IIRA’s website www.iirating.com makes full disclosure regarding its ownership, management, rating methodology for all its services and rating scales and definitions
THANK YOU
Agrofinmost

HSE – Skolkovo Institute for Law and Development

Boosting Russian agricultural exports and securing food supply to Islamic countries through Islamic finance mechanisms
PROJECT BACKGROUND

Challenges

• Oligopolistic structure of the global food market
• Important role of speculative forces
  High dependence on stock exchange trade controlled by speculative capital
• Lack (high cost) of long-term investment and lending for small and mid-sized farmers in Russia
• Legal complexities of obtaining a loan for small and mid-sized farmers in Russia
• Decreasing marginality of Russia’s agricultural sector
• Underdeveloped export infrastructure in Russia
• No link between producer and exporter
• Segments which are the most capital intensive and most volatile get smallest profits, and vice versa

Opportunities

• High demand for food security in Islamic countries
• Availability of uncommitted financial resources in Islamic countries, esp. from conservative investors (e.g., family offices)
• Demand for more stable and less speculative relations with food suppliers, based on the principles and values of Islamic law
• Demand for cheaper grain by eliminating unnecessary middlemen
• Expansion of grain production in Russia subject to stable funding
• Conformity of Russian grain with the quality standards set for Muslim countries’ social programmes
• Opportunity to develop new logistic routes to Muslim countries (a range of alternative solutions, including the North-South international transport corridor)

Boosting Russian agricultural exports and securing food supply to Muslim countries
PROJECT GOAL AND OBJECTIVES

Goal

Establish long-term sustainable partnership mechanisms for the supply of Russian agricultural produce to Muslim countries using partnership financial instruments based on the principles of Islamic law

Objectives

• Lay the groundwork for long-term sustainable financing of Russia’s agricultural production and exports

• Contribute to Islamic countries’ food security

• Build up food reserves jointly controlled by project participants, which can serve as a collateral for the securities to be issued as part of the project

• Implement partnership financial instruments on the world agricultural market

• Establish new pricing mechanisms in the global food trade

• Build long-term relations Islamic investors

• Develop cross-border logistics infrastructure in Russia and in food importing countries, jointly owned and controlled by project participants
GLOBAL PROBLEMS OF THE AGRIFOOD MARKET. HUNGER

Agriculture is affected by climate change.

+ According to FAO, with demand for grain reaching 2.7 bn tonnes in 2030, grain production will only be as low as 2.1 bn tonnes.*

= FAO’s forecast for combating global hunger is overly optimistic.

In the near future, the global food system will be under an unprecedented pressure:

01 Tightening competition for land, water and energy.

02 Population growth to more than 9 bn people by 2050; according to World Bank, global demand for food is projected to increase by around 70% with estimated extra investments of $80 bn/year needed to meet it. **

We are concerned that, after many years of decline, global hunger increased in 2016 and now affects 815 million of the world population, and that about 2 billion people suffer from micronutrient deficiencies.

2018 Declaration of the G20 Meeting of Agriculture Ministers*

<table>
<thead>
<tr>
<th>Region</th>
<th>2000</th>
<th>2010</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Asia</td>
<td>180</td>
<td>240</td>
<td>300</td>
</tr>
<tr>
<td>East Asia</td>
<td>360</td>
<td>400</td>
<td>420</td>
</tr>
<tr>
<td>MENA</td>
<td>70</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>Latin America</td>
<td>70</td>
<td>60</td>
<td>50</td>
</tr>
<tr>
<td>Africa</td>
<td>170</td>
<td>160</td>
<td>50</td>
</tr>
</tbody>
</table>

This is the third consecutive year that progress in ending hunger has stalled and now hunger has actually increased (in 2015, 2016 and 2017).

* [FAO, 2018]. ** [Maram Ahmed].

FAO Director General
José Graziano da Silva
OLIGOPOLISTIC STRUCTURE OF THE GLOBAL FOOD MARKET

A few companies (ADM, Bunge, Cargill, Louis-Dreyfus, Glencore, etc.)

- dominate the global food market
- have departed from the original business model of buying and selling food and have come to resemble ‘value chain managers’ involved in food production, processing, distribution, financing and investment*
- operate within an oligopolistic global grain market and exert major influence on the world food system, posing a risk to the welfare of consumers**
- traders’ vertical and financial integration is tightening with horizontal integration expanding (entering new markets)**
- Russia being #1 exporter globally and having 10% of world’s arable land, there are no major Russian players in this circle

*** Clapp, 2015, p. 129–130.
**** Clapp, 2015, p. 130–131.

imposing prices and terms on smaller producers
affecting people’s access to food***
unstable political and social environment in food importing countries

This may have contributed to the ‘Arab Spring’ events****
Commodity prices are increasingly influenced by factors that have nothing to do with physical reserves, while there is at least a short-term impact on food prices as a result of increased financial speculation.*

Increasing financialization of commodity production with hedge funds, private equity funds and others investing directly in land and agricultural production.**

Wheat price and supply volatility (driven by, e.g., financialization, consolidation of TNCs trading wheat, etc.) negatively affect importing MENA countries, which have to work with traders to offset short domestic food supply with imports.***

Most banks finance grain from the moment it is on board of a vessel in an export port, while its domestic production and storage is not or insufficiently financed, giving even more leverage to a small range of trading companies.

** Ibid., p. 36.
SPECULATIVE PRICING

World wheat prices, 1998-2018

World wheat consumption, 1998-2018

Data on wheat price (wheat, No. 1 Hard Red Winter, ordinary protein, Kansas City): IMF Primary Commodity Prices
Data on wheat consumption: OECD-FAO Agricultural Outlook 2018-2027
President Putin’s May 2018 Decree: Agricultural exports to reach $45 bln in 2024 (from $24 bln in 2018)

With its vast expanses of arable land in areas where climate is conducive to crop farming, Russia is well positioned to be a key supplier of grains to the world markets. Over the last 20 years, the country has achieved a two-fold increase in grain production (from 65.4 mln tonnes in 2000 to 135.3 mln tonnes in 2017) and has converted from a net importer to a net exporter of grain.

Today, Russia’s potential for both intensive and extensive growth in this area is far from being exhausted.
According to some expert estimates, Russia’s grain sector has the potential to produce up to 100 mln tonnes of grain in excess of domestic consumption and to establish itself on the world market as a leading supplier of grain.

Gross yield and domestic consumption of wheat, mln tonnes

Gross yield (Rosstat)
Domestic consumption (IKAR, ProZerno (for 2018))
NEW MARKETS

Afrika – 7,2 mln t
Vietnam – 2,6 mln t
Bangladesh – 1,8 mln t
Indonesia – 1,4 mln t
Philipinnes – 1,1 mln t
AGROFINMOST PROJECT CONCEPT

Create a **grain security fund** in one of the Gulf countries.

Invest the proceeds in the Russian agricultural sector by **advancing working capital to Russian grain producers** and engaging in other income-generating activities:

- Management of grain reserves outside Russia;
- Management of other assets;
- Grain trading on spot basis;
- Grain trading on deferred payment basis.

Raise capital using the fund as the underlying asset.

Incorporate the grain security fund in the supply chain of a food processing cluster outside of Russia.
The main function of the fund is to secure grain supplies to the consumers of the region:

1. When a trigger event arises (disruption of grain supplies, shortage of grain, price exceeding a threshold level, etc.), the fund is used to ensure an uninterrupted supply of grain to the public of the host country and a broader region.

2. At other times, the fund is in constant circulation: it may be sold for processing, etc. Grain that has been disposed of is replaced with new supplies.

3. In any event, a pre-determined minimum stock level is maintained at all times.

4. This minimum stock defines the value of the fund, against which financial instruments may be issued.

Setting up the fund in a location outside of Russia:

1. Improves grain availability for the consumers in the region: the grain from the fund can be shipped for consumption within a short period of time.

2. Increases the value of the grain and transforms it into an asset against which capital can be raised.

3. Levels out the export cycle by smoothing peak loads on the transport and logistics infrastructure.
ADVANCING WORKING CAPITAL TO FARMERS

The capital raised against the fund is used to advance working capital to Russian ag grain producers:

1. The foreign issuer of securities transmits the capital to the Russian management company as advance payment for future grain.

2. The management company advances to grain producers (under a deferred delivery contract):
   - High-yield grains
   - Agrochemicals
   - Fuels
   - Fertilizers (blends)
   - Digital services

3. On maturity, the grain producers supply grain of stipulated quality to the management company.
GENERAL PROJECT CHART

Food Processing Cluster

Grain Security Fund

Grain storage management company (SPV-2)

Capital raised from investors

Issuer of securities against the fund (SPV-1)

Management company (Russia-based)

Russia

Farmers, agricultural producers
Stage 0

Preliminary agreements with potential project partners, investors and contractors.
Legal formalities

Stage 1

Grain Security Fund

Implementation:
1. Purchase ca. 0.5 mln t (~$100 mln worth) of wheat on the spot market and place it in a storage facility outside of Russia
2. Establish a grain security fund, define its rules of operation, including:
   • The minimum stock level;
   • The stock rotation method (FIFO);
   • A contract for physical protection of the stock with an independent security services provider.
3. Potential host countries: Egypt, Turkey, Lebanon, UAE, Iran
AGROFINMOST PROJECT TIMELINE (2/2)

Stage 2  Capital raising outside Russia (SPV-1)
The grain security fund to serve as the underlying asset of the issue.
Pilot issue size: from $200 to $500 mln.

Income generating activities:
• Advancing of working capital to Russian grain producers
• Spot purchases of Russian grain and and its sale in importing markets
• Grain storage and processing plants in importing countries
  (Egypt being the first target country)

Potential guarantees for investors:
• Minimum balance of grain security fund
• Government guarantees
• Personal guarantees of producers
• Producers’ land
• Joint responsibility and common assets of cooperatives

Stage 3  Further project expansion

- Spot wheat trading
  (Russia and Muslim countries)
- Wheat processing plants in Muslim countries
- Advancing working capital to grain producers in Russia

Income generating activities for SPV-2
ISLAMIC FINANCE: POTENTIAL ROLE IN BOOSTING GRAIN EXPORTS (1/2)

Benefits of Islamic financial instruments

- Countries of the Islamic world are among the key importers of Russian agricultural produce
- Islamic investors are interested in humanitarian supplies of food to the region to secure social peace
- Opportunity to attract a wide range of investors from destination countries, including the most conservative ones
- Broader range of investors, including Islamic and conventional ones
- Broad spectrum of instruments that can be used depending on transaction objectives

The main export destinations are Middle East countries (including Egypt, Saudi Arabia, Iran, Libya, etc.)

*from a presentation of Novorossiysk Grain Products Company (Russia)*

### TOP 20 importers of Russian grain (mлn tonnes, 2018/2019 season)

- **Egypt**: 7.6
- **Turkey**: 5.5
- **Iran**: 2.4
- **Vietnam**: 2.1
- **Bangladesh**: 1.6
- **Saudi Arabia**: 1.4
- **Nigeria**: 1.4
- **Latvia**: 1.3
- **Sudan**: 1.16
- **Indonesia**: 1.16
- **Yemen**: 1.1
- **Lebanon**: 0.92
- **Philippines**: 0.92
- **Jordan**: 0.78
- **Kenya**: 0.77
- **Azerbaijan**: 0.64
- **UAE**: 0.63
- **Morocco**: 0.57
- **Mozambique**: 0.53
- **Mexico**: 0.48

Source: agroinvestor.ru
Universal human values at the core

- Prohibition on interest
- Prohibition on speculation and speculative instruments
- Prohibition on excessive uncertainty in transactions (including derivatives)
- Real asset-based contracts
- Principles common to all world religions and universal human morals
# SOME FORBIDDEN AND DISLIKED ELEMENTS IN CURRENT COMMODITY TRADING

## PHENOMENON & ARABIC TERM

<table>
<thead>
<tr>
<th>Phenomena</th>
<th>Arabic Term</th>
<th>Consequence</th>
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</thead>
<tbody>
<tr>
<td>Riba (ربا) Usury</td>
<td></td>
<td>Companies use commodity repo transaction in order to get short term financing</td>
</tr>
<tr>
<td>- Interest based financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Repo transactions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gharar (غرر) Uncertainty with regards to one of the contract pillars:</td>
<td></td>
<td>High level of uncertainty related to price and terms of delivery of food commodities.</td>
</tr>
<tr>
<td>- sale of unidentified and non-quantified goods</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- sale with voidable condition</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- sale without stipulating certain price</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- other types of gharar (see below)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short selling (بيع قبل القبض) and other types of unsecured transactions:</td>
<td></td>
<td>Selling of grain before possessing it is a popular transaction on the market</td>
</tr>
<tr>
<td>- sale of goods before possessing it</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- sale of good before they appear</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- future and forward selling</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maysir (ميسر) Gambling</td>
<td></td>
<td>Traders are speculating on price on commodity exchanges resulting in price violation, including the use of derivatives</td>
</tr>
<tr>
<td>Approaching the sellers (producers) before they enter the city (market) (تنقي الجهب) (makrooh)</td>
<td></td>
<td>Huge difference in ex-works and FOB price, the food producers are unable to take part in commodity food trading at large markets</td>
</tr>
<tr>
<td>Najash (نجش) Use of the information asymmetry in order to speculate with the price (makrooh)</td>
<td></td>
<td>Sometimes small producers are unaware of real market price of the products</td>
</tr>
<tr>
<td>Ihtikar (إحتكار) Buying out and retaining products that results in raising prices</td>
<td></td>
<td>Some traders buy out and hold food commodities during the upward price trend that results in raising prices</td>
</tr>
</tbody>
</table>
RUSSIA ON THE ISLAMIC FINANCE MARKET

Islamic finance in the world

<table>
<thead>
<tr>
<th>Parameter</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets of Islamic banks</td>
<td>$1,765 bn</td>
</tr>
<tr>
<td>Nr of Islamic financial companies</td>
<td>1,407</td>
</tr>
<tr>
<td>Total worth of sukuk</td>
<td>$426 bn</td>
</tr>
<tr>
<td>Nr of sukuk outstanding</td>
<td>2,590</td>
</tr>
<tr>
<td>Total worth of funds managed</td>
<td>$110.1 bn</td>
</tr>
<tr>
<td>Nr of Islamic funds</td>
<td>1,410</td>
</tr>
<tr>
<td>Regulation of Islamic finance</td>
<td>-</td>
</tr>
<tr>
<td>Nr of Sharia scholars</td>
<td>1,162</td>
</tr>
<tr>
<td>Rating as per published reports</td>
<td>33.11</td>
</tr>
<tr>
<td>Educational programmes</td>
<td>688</td>
</tr>
<tr>
<td>Research works</td>
<td>2,542</td>
</tr>
</tbody>
</table>

Source: HSE, based on zawya.com 2017 data

Islamic finance assets, $bn (world)

- Islamic banks, 1,721, 71%
- Sukuk, 426, 17%
- Takaful (insurance), 46, 2%
- Other, 135, 6%
- Invsmt funds, 110, 4%

Russian market: untapped potential?

- Islamic financial companies' assets: ~ $20 mn
- Other transactions: ~ $200 mn
- Tawarruq financing: $160 mn
- Sukuk financing: 0

Source: HSE, based on RAEIF 2017 data
SUKUK IN RUSSIA: LACK OF SUCCESSFUL STORIES

- Pilot issue of sukuk mudaraba at MICEX (~$15,000)
- President of Tatarstan announces plans to issue sukuk to finance Kazan Smart City
- IFC Linova (Kazan) announces plans to issue a $200 mln-worth of sukuk together with Malaysian companies
- VTB Capital plans a $200 mln-worth sukuk ijara issuance

HSE – Skolkovo Institute for Law and Development
SUKUK IN RUSSIA: MARKET OVERVIEW

Why Russia lacks positive experience on the sukuk market

- General decline in investor activity due to 2007-2008 crisis
- The sukuk structures were not mature enough until recently
- Lack of stable cross-cultural communication between Russia and the Islamic world. Deficit of trust
- Lack of positive history of interaction with conservative Islamic investors
- Scarcity of projects strategically interesting to investors
### Selection of Sukuk Structure

<table>
<thead>
<tr>
<th>Structure</th>
<th>Type of income</th>
<th>Tradable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sukuk Salam</td>
<td>fixed</td>
<td>no</td>
</tr>
<tr>
<td>Sukuk Murabahah</td>
<td>fixed</td>
<td>no</td>
</tr>
<tr>
<td>Sukuk Musharakah</td>
<td>not fixed</td>
<td>yes, if no less than 33% of sukuk assets are illiquid assets</td>
</tr>
<tr>
<td>Sukuk Mudarabah</td>
<td>not fixed</td>
<td>yes, if no less than 33% of sukuk assets are illiquid assets</td>
</tr>
<tr>
<td>Sukuk Istisna</td>
<td>pre-determined pricing formula</td>
<td>yes, after the asset has been produced</td>
</tr>
<tr>
<td>Sukuk Wakalah al-Istithmar</td>
<td>pre-determined pricing formula</td>
<td>yes, if no less than 33% of sukuk assets are illiquid assets</td>
</tr>
</tbody>
</table>

Source: AAOIFI (2017), Standard No. 17 ‘Investment Sukuk’
FINANCIAL AND INVESTMENT TOOLS: SUKUK SALAM*

The issuer of such certificates (‘food bonds’ or ‘agribonds’) sells goods to buyers, i.e. sukuk subscribers, on deferred delivery terms; the proceeds from subscription constitute the purchase price (salam capital) of the goods.

The holders of sukuk (investors) are the owners of the goods and are entitled to the sale price of the goods.

![Diagram showing sukuk salam process]

1. liability
2a. sukuk certificates
3. proceeds from salam transaction
2b. proceeds from sukuk certificates
4. goods
5. goods

Source: AAOIFI Sharia standards

Types of sukuk, nr of issues, 2017

- Others; 165; 17%
- Mudaraba; 188; 19%
- Hybrid; 149; 15%
- Murabaha; 177; 18%
- Ijara; 157; 16%

Source: Thomson Reuters

* This is but one example of a sukuk transaction structuring. In practice, sukuk may as well be based on other contracts, including hybrid ones.
FINANCIAL AND INVESTMENT TOOLS: SUKUK MUSHARAKA*

Equal value certificates, issued for using the funds received to establish a new or develop an existing project on the basis of any of the partnership contracts. The certificate holders become the owners of the project or of the assets of the activity as per their respective shares. The musharaka certificates are structured on the basis of participation, or fiduciary management, or an investment agency.

**Benefits of sukuk musharaka structure**

- Sukuk musharaka certificates can be traded on the secondary market (unlike, e.g., sukuk salam)
- Moderate risks for the investors
- More options for deal structuring depending on contract and project specifics

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**Diagram Notes:**

1. **Originator (initiator)**
2. **Originator (management company)**
3. **Musharaka (joint venture)**
4. **SPV Issuer**
5. **Investors (sukuk holders)**

1a. Investments
1b. Sukuk certificates
2. Profits from the project
FINANCIAL AND INVESTMENT TOOLS:
SUKUK WAKALA BIL ISTITHMAR

Participation certificates managed on the basis of investment agency
The issuer of these sukuk is an investment agent, the subscribers are the principals and
the realised funds are the subject matter of investment under an agency agreement.
The holders of sukuk own the assets represented by the certificates with its benefits
and risks and are entitled to profits from the partnership, if any

Share of Sukuk al Wakala in different issuances by issue size, 2018
(international issues)
• Sovereign issuances – 34% (top 1)
• Quasi-Sovereign issuances – 92% (top 1)
• Corporate issuances – 31% (top 2)
• Islamic financial companies’ issuances – 25% (top 1)

Sukuk wakala issuances in 2018 (individual landmark issuances):
• IDB (3 issuances)
• Central Bank of Qatar (4 issuances)
• First Abu Dhabi Bank (1 issuance for 650 mkn USD)
• Noor Bank, Dubai (1 issuance for 500 mln USD)
• Medco Power, Indonesia (1 issuance for 426 mln USD)

Source: IIFM, 2019
SUKUK STRUCTURE FOR AGROFINMOST (WAKALA BIL ISTITHMAR)

- **Sukuk holders (investors)**
  - Asset redemption value (sukuk redemption at residual value)
  - Profit as per agreement
  - Investments
  - Certificates

- **SPV (issuer)**
  - Investment agency agreement (agent appointment)
  - Profit margin: x %

- **Asset musharaka pool**
  - Agency commission
    - Profit – x%
    - Mgmt/agent
  - Profits / inflows
  - Sale / service provision
  - Buyers / customers
  - Suppliers of other assets

- **Profit equalisation reserve**

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Russia
NOTES ON SUKUK STRUCTURE (1/3)

**Investment agency agreement**

Sukuk holders appoint a management company as an agent to set up and manage the investment portfolio (asset pool). The contract must specify the nature of the assets, e.g.:
- Real estate
- Property to lease out
- Goods for sale (e.g., grain)

The investment agent must ensure that the asset time ratio is maintained: illiquid assets must be above 33% of the portfolio. (All cash and receivables are liquid assets)

The income generated by each asset type in the portfolio is divided between investors and the management company. The management company:
- is entitled to all the profits in excess of the pre-determined rate stipulated in the contract;
- receives a fixed agency fee.
NOTES ON SUKUK STRUCTURE (2/3)

Lease asset management

Such assets, together with other illiquid assets, are purchased under an Asset Purchase Agreement. They must represent 33% or more of the portfolio value (for sukuk to be tradeable on the secondary market: AAOIFI Standard 21, item 3.19)

Upon maturity of sukuk, the assets are bought out from sukuk holders at residual value under an Undertaking to Purchase (UTP)

After purchase, such assets are leased out under a Lease Agreement. The size of lease payments must meet a pre-define criterion

If the assets were purchased from the issuer (the borrower) and then leased back to the issuer, at the end of the lease the issuer repurchases it, then minimum period of lease must be 1 year (as per AAOIFI standards)
Current asset management (grain)

The proceeds of the sukuk issue are invested in grain trading contracts (no more than 67% of contract price).

- The management company seeks to achieve the pre-determined profit margin stipulated in the business plan and agreement. If the actual profits exceed the pre-determined margin, the company may keep the excess profits (fixed agency fee plus incentive).

- Every six or four months (depending on the documentation), the management company makes distribution of profit to investors. After financial statements are out, the disbursements are reassessed. Reserves can be created to adjust any variation at the end of the year.
SUKUK ISSUE DOCUMENTATION

- **Investment agency agreement**
  (between Investment Agent and Participants)

- **Agency agreement**
  (between Investment Agent and Sukuk Issuer)

- **Asset purchase agreement**
  (between Investment Agent and Sukuk Issuer)

- **Lease agreement**
  (between Investment Agent and Sukuk Issuer)

- **Undertaking to Purchase**
  (by Sukuk Issuer)

- **Security documents, guarantees**
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مؤتمر أيوفي – البنك الدولي السنوي الرابع عشر
التحولات الجذرية في منظومة المالية الإسلامية الدولية
الحاجة إلى الحوكمة والمعيِّرة والدعم الرقابي

3-4 نوفمبر 2019

عملية اتخاذ القرارات الشرعية

د. عبدالباري مشعل
الشريك المدير – شركة رقابة (أمريكا)

مقدمة

تتناول هذه الورقة إضاءةً مختصرةً للمسودة الأولية غير المعتمدة من معيار الحوكمة رقم 12 بشأن عملية اتخاذ القرارات الشرعية والدراسة الأولية للمعيار وبعض الدراسات الأخرى ذات الصلة.

وقد هدف المعيار إلى صياغة إطار عمل لعمليَّة اتخاذ القرارات الشرعية في المؤسسات المالية الإسلامية بغرض تنميط الممارسات حول العالم. هناك جانبين في هذه العملية، الأول: إصدار الفتوى وهو الذي تمت تغطيته بالمعيار الشرعي رقم 29 بشأن ضوابط وأخلاقيات الفتوى، والثاني: ضوابط الحوكمة الخاصة بالحصول على الفتوى وتطبيقها، وهي موضوع معيار الحوكمة رقم 12.
عملية اتخاذ القرارات الشرعية - د. عبدالباري مشعل

والدافع لهذا الموضوع أن عملية اتخاذ القرارات الشرعية تتطوي على مخاطر متعددة، ولذا فإن هذا المعيار يتضمن توجيهات تفصيلية بشأن تحسين العلاقة بين هيئة الرقابة الشرعية وإدارة المؤسسة المالية الإسلامية وتعزيز التعاون بينهما في هذا الشأن.

ويشمل نطاق المعيار؛ المجالات التي تصدر بشأنها القرارات الشرعية، الاعتبارات الجوهرية التي يجب مراجعتها في اتخاذ القرارات الشرعية، عملية تطوير المنتجات، دور ومسؤولية أجهزة الحوكمة المختلفة المتدخلة في هذه العملية، آليات تطبيق وتبلغ إطار العمل المقدم في هذا المعيار.

1. مجالات القرارات الشرعية:

1.1. اعتماد المنتجات: يفرق المعيار بين نوعين من المنتجات:

1.1.1. المنتجات النمطية الخاصة بالمؤسسة نفسها، وهذا تتطلب النظر الشرعي في الآتي كحد أدنى:

- مذكرة عرض معد من القسم الشرعي الداخلي، مراجعة شرعية لاتفاقيات المعتمدة من الإدارة القانونية بالمؤسسة، مراجعة شرعية للجهوب المالية، مراجعة شرعية لنظام المعلومات الآلي، ومراجعتشريعة لأدلة العمل ذات العلاقة.

1.1.2. المنتجات غير النمطية المعتمدة من هيئة تشرعي أخرى، مثل السكوك والتمويل الجماعي ومشروعة الاستثمار، وغيرها، وهذه تتطلب النظر الشرعي في الآتي: مراجعة الهيكل والمستندات ذات العلاقة، أو المصادقة على الفتوى المصدرة الهيئة الشرعية الأخرى.

1.2. الاستفسارات: ويفرق المعيار بين نوعين من الاستفسارات:

1.2.1. استفسارات خاصة بالمعاملات.
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2.2.1. استفسارات لا علاقة لها بالمعاملات:

- استفسارات مالية، مثل تطبيقات المحاسبة، سياسة المخصصات، حساب الزكاة، التصرف في حساب الخيرات، تعديل مبلغ الضرائب وغيرها.

- استفسارات غير مالية، مثل مواد التسويق، الموارد البشرية، أنشطة العلاقات العامة.

1.3. التحفظات الشرعية: الهيئة الشرعية تتظر في هذه التحفظات للتوجه بتصحيحها ومعالجتها، وعلى الهيئة الشرعية أن توجه المؤسسة لتبني منهجية، أو إجراءات خاصة لتجنب مخالفة الشريعة.

2. الاعتبارات الجوهرية في اتخاذ القرارات الشرعية:

يجب على هيئة الرقابة الشرعية أن تأخذ في الاعتبار العوامل التي تؤدي إلى إمكانية اتخاذ قرارات غير مرغوب فيها يمكن أن تؤثر على مخرجات القرارات الشرعية وقد تؤثر سلباً على أهداف المؤسسة بصفة عامة. وتشمل هذا الاعتبارات التي ينبغي تجنبها:
Fatwa preference 2.1.

Lack of consultation 2.2.

Considerations in Shari’ah decision-making

Fatwa preference:

- the arbitrage should be avoided

Lack of consultation:

- Fatwa rejection

Psychological impacts:

Considerations in Shari’ah decision-making:

2.1. Fatwa preference

2.2. Lack of consultation

2.3. Psychological impacts
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4.2.2. عدم أخذ الاعتبارات الدينية والقانونية والعملية بشكل كاف، وظهور الفتوى بأن تصورات نظرية لا علاقة بواقع الأسواق.

Psychological Impacts 2.3

2.3.1. علی الهيئة الشرعية أن تتجنب التأثيرات النفسية التي يمكن أن تؤدي إلى التحيز في اتخاذ القرارات الشرعية المختلفة على مستوى المنتجات والاستفسارات والملاحظات. وتعد هذه التأثيرات بمثابة مصائد خفية (hidden traps) لمنتخذ القرار الشرعي. وتعالج هذه المخاطر الخفية (skills of critical Shari’ah analysis).

س.2.3.2.
عملية اتخاذ القرارات الشرعية - د. عبدالباري محلة

3.2.3. وتعد هذه التأثيرات بمثابة مصائد خفية (hidden traps) لمتخذ القرار الشرعي. وتعالج هذه المخاطر الخفية ينبغي تطوير مهارات التحليل الشرعي النقدي (skills of critical Shari’ah analysis). ووفقًا للتحليل النقدي ينبغي للهيئة الشرعية مراعاة الآتي:

- تجنب قبول التصور الأولي، وبذل الجهد في التصور الصحيح من خلال تحقيق المناط في المسألة المعروضة.
- تقييم وتحليل كل الخيارات المتاحة وعدم التخوف من الاجتهاد ومخالفة التطبيقات السائدة، وتجنب الركون للوضع القائم.
- عدم الاقتصار على المعلومات الأولية وطلب بحوث إضافية من أمانة الهيئة أو إدارة الالتزام الشرعي.
- ولا بد من مراجعة الفتوى المبكرة التي صدرت في ضوء حقائق وظروف طرأ عليها التغيير.
- وعدم تتبّع الأقوال بغرض تأييد رأي محدد مسبقًا.
- وعدم الخضوع لتخويف الإدارة بحدوث الخسائر أو فقدان الأرباح.
- وأخيرًا يجب على الإدارة عدم ربط قرار الهيئة مهما كان نوعه بأحداث مصاحبة إبرازه كسبب له.

ويسند في تخفيف هذه المخاطر تحقيق الاستقلالية وتجنب تعارض المصالح في كل وظائف الحوكمة، ومنهجية تطوير المنتجات ومدى مراعاة مقاصد الشريعة وأهداف التنمية المستدامة، وسأبّاتي بيان ذلك.
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3. تطوير المنتجات

Product development process (PDP)

3.1. عملية تطوير المنتجات

3.2. بعض المخاطر التي تؤثر على القرارات الشرعية تعود إلى غياب عملية تطوير منتجات في المؤسسة. لتخفيض المخاطر يجب أن تعتمد نموذج شامل لتطوير المنتجات:
- التصميم
- الموافقة الشرعية
- الاختبارات
- التسويق
- التنفيذ
- التغذية الراجعة.

3.3. اعتبارات التنمية المستدامة من خلال مقاصد الشريعة

Consideration of SDGs through Maqāṣid Al-Shari’ah

ينبغي تشجيع المؤسسات المالية الإسلامية على مراعاة الأهداف 17 للتنمية المستدامة الصادرة عن الأمم المتحدة، هذه الأهداف تشمل تطوير الأبعاد الاجتماعية والاقتصادية والبيئية وغيرها، وهي تتفق مع أهداف ومبادئ الشريعة الإسلامية. ومن الملائم وضع إطار لدمج هذه الأهداف ضمن مقاصد الشريعة التي تحكم عمليات المؤسسات المالية الإسلامية.

4. دور ومسؤوليات أجهزة الحوكمة المتدخلة في اتخاذ القرارات الشرعية

4.1. هيئة الرقابة الشرعية

1.1. ينبغي اتباع منهج التحليل الشرعي النقدي لتخفيض المخاطر، والمصائد الخفية، التي من شأنها أن تؤثر سلبياً على عملية اتخاذ القرارات الشرعية، كما سبق بيانها من قبل.
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2.4.1.4.1. يضاف إلى ذلك تحقيق الاستقلالية وعدم تعارض المصالح في جميع أعضاء هيئة الرقابة الشرعية بمن فيهم العضو التنفيذي، وعلى سبيل المثال يجب تقديم الاستشارات الشرعية، التدريب، الحصول على تمويل بنظام تفضيلية، علاقة القرابة من الدرجة مع كبار المسؤولين أو المدراء التنفيذيين، وتجنب مشاركة العضو في التصويت أو حضور الاجتماع في موضوع يهدد الاستقلالية الخاصة بذلك العضو. ويمكن أن يكون أي من أعضاء الهيئة موظفين أو مدراء تنفيذيين في المؤسسة، كما يمنع أن يشاركوا في أي قرارات تنفيذية.

2.4.1.3. يجب أن تتضمن الفتوى في الحد الأدنى ما يأتي: هيكل المنتج مع الشرح المفصل، وملخص لتفديف العمليات، المستندات ذات العلاقة بالعقد الأساسية، الاستفسار الأصلي أو التحفيزات المرفوعة للهيئة، ملخص الأحكام الشرعية والشروط التجارية، الضوابط الرقابية الخاصة بمخاطر عدم الالتزام الشرعي المحتملة، الأساس الشرعي للفتوى المصدرة، التحفظ والمخالفاة للرأي إن وجد مع ذكر السبب، وذكر اسم وتوقيع كل عضو.

4.2.1. أمانة هيئة الرقابة الشرعية:

4.2.1.2. تستعين الهيئة بجهاز الأمانة أو إدارة الالتزام الشرعي في حال غياب جهاز الأمانة، في تحضير الدراسات الخاصة بالأعمال المعروضة على الهيئة.

4.2.4.1.4.3. تقديم دراسات ملهمة لهيئة الرقابة الشرعية يجب على الجهاز المساند تطبيق تقنية إل أر أي (Legal documentation, Risk management and Accounting treatment) لضمان أن القرار الشرعي لم يغفل الجوانب القانونية، المحاسبية،
عملية اتخاذ القرارات الشرعية - د. عبدالباري مشعل

إدارة المخاطر المتعلقة بعمليات الشركة وسمعتها. وينذر في الدراسة المقدمة أي تعليمات للبنك المركزي أو للمعايير الشرعية تتعلق بالموضوع محل العرض.

4.2.3 بعد صدور القرار يعود إلى الإدارة القانونية، والمحاسبة، إدارة المخاطر لفحص وتقييم تأثيره على عمليات المؤسسة، وعلى مستوى التطبيق يجب تبليغ الهيئة بتطبيق القرار أو عدم تطبيقه كليا أو جزئيا مع بيان الأسباب.
عملية اتخاذ القرارات الشرعية 

د. عبدالباري مشعل

4.3. الإدارة:

4.3.1. لضمان دقة القرار الشرعي، يجب على الإدارة تقديم معلومات صحيحة، وكاملة، وتجنب تقديم تفسيرات أو إيضاحات حسب تقدير الإدارة دون الرجوع للجهات المختصة بشأن الموضوع محل العرض.

4.3.2. توفير التدريب والتوجيه المناسب للأجهزة ذات العلاقة باتخاذ القرار الشرعي.

4.3.3. ولا ينبغي أن تحيز الإدارة ضده أو مقترح جديد يتحدى التطبيقات السائدة.

4.3.4. تجنّب الطلب بالإلحاح من الهيئة الشرعية أن توافق على المنتجات والخدمات بسبب أنها أجمزة من علماء وزمالاء أو مدارس فقهية أخرى مخالفة، أو مؤسسات منافسة.

4.3.5. تجنّب الضغط باتجاه الفتوى المحددة مسبقًا.

4.3.6. إجمالًا يجب عرض جميع الأعمال على الهيئة.

تم بحمد الله في مطار هانيدا- طوكيو في الطريق إلى كولالمبور.

د. عبدالباري مشعل

2019/10/30
Special event
‘Islamic Finance for Food Security: Connecting Russia and Muslim Countries’

held by HSE-Skolkovo Institute for Law and Development

chaired by Sheikh Muhammad Taqi Usmani,
with contributions by Shari’ah scholars and Islamic finance industry experts

supported by AAOIFI and in association with Usmani and Co during the

14th AAOIFI — World Bank Conference
‘Revolutionary Changes in Global Islamic Finance Ecosystem: Need for Governance, Standardization and Regulatory Support’

RESOLUTION

Participants of the special event ‘Islamic Finance for Food Security: Connecting Russia and Muslim Countries,’

Taking into account the keynote speech delivered by Sheikh Muhammad Taqi Usmani and the presentation of the Agrofinmost project made by the HSE-Skolkovo Institute for Law and Development;

In view of the opinions expressed by and contributions made by attendees;

Having regard to the discussions held as part of the event,

have agreed that:
1. Food security is an urgent concern requiring innovative solutions.

2. The contemporary food trade model is unsustainable, characterized by monopolisation and speculation, and is in conflict with the basic principles of fair trade, incapable of delivering food to all people, as a public good and not as an object of speculation.

3. Alternative models of farmer financing are required that would meet the needs of market participants.

4. Islamic finance instruments, in particular sukuk, may be a viable alternative to industry-distorting instruments, such as speculative futures, and will attract a wider base of investors, including those who focus on ethical investments.

5. The Agrofinmost project and the solutions it proposes have the potential to improve food security of the Muslim countries dependent on food imports.

6. The project proposes a fairer and more equitable model of food trade based on the principles of Islamic financing while safeguarding the interests of food producers and consumers alike.

7. The project has the potential to reduce the cost of food to combat hunger, give the underprivileged rural population broader access to food resources and bring peace to society.

8. The project will set up sustainable trade corridors between Russia, its neighbouring countries and the Muslim world for the benefit of the wider community.

9. Islamic businesses, institutions and governments are encouraged participate in the Agrofinmost project for their own benefit and for that of the Muslim community at large.