ISLAMIC BANKING AND FINANCE TUNISIAN CASE

September 2010

I. History

Islamic finance has emerged since the 1970s, except that the benefits of this finance based on principles and values in accordance with *Sharia* only became apparent with the proliferation of crises and the strong shock supported by conventional banks. Since its inception in the mid-1970s, Islamic finance has gradually managed to assert its place in the financial system in many Muslim countries. Far from remaining a mere fad, it has also freed the industry niche status to become an important cog in the financial channels of savings.

Islamic banking is distinguished by the originality of its founding principles and it offers new solutions according to the precepts of *Sharia*. Its advantage of being open to non-Muslims allowed it to score a growth rate of 29.7% over 2005. Similarly, interest in a population of 1.3 billion Muslims, 13 million in Europe and 5 million North American is considered so important.

Since the financial crisis, Islamic finance has been erected as an alternative to conventional financial system.

The Emergence of Islamic banks

Some argue that the market for Islamic finance is booming while others see it is not about solving problems and crises of today with yesterday's solutions. Nearly 345 financial institutions practicing Islamic confidence in the world in 80 countries. The scope of Islamic banks differs from one country to another in a few countries, the banking sector is entirely Islamic (Iran, Sudan), in others, both systems, conventional and Islamic, coexist (UAE, Indonesia, Malaysia, Pakistan, Tunisia), and in still others, there are only a few Islamic banks.

While some countries have opted for a clear separation between the two sectors, others have allowed conventional banks to open Islamic banking. Assessing the importance of the role of Islamic finance in the financing of national economies must take into account these differences. In fact, Didier Planche (2007), notes that the poor development of Islamic finance in the Maghreb countries seem surprising given that the population is very sensitive to the religious argument and low levels of bank penetration posted in these countries (Morocco 25% , Algeria 20%, Tunisia 33%).

The growth in *Shariah*-compliant assets has been dramatic over the past decade. Current global Islamic finance assets stand at US$800 billion and could hit US$4 trillion by 2015. With an annual average growth rate of between 10 and 20%, Islamic finance is among the fastest-growing financial industries. However, all MENA countries are not performing equally.

Based on an analysis of market capitalization, market capitalization over GDP ratio and share of Islamic assets in total assets, the countries included in the study can be divided into three groups: the “big 4”, the challengers and the newcomers.

The “big 4” group contains the KSA, Kuwait, Malaysia and the UAE. Capital markets in these countries are highly developed. The market capitalization is high as is the share of Islamic assets. For instance, in Malaysia and Kuwait the market capitalization over GDP ratio is 92% and 76% respectively. KSA, by far the largest Arabic capital market, also has the largest concentration of Islamic finance assets (40%), followed by Kuwait (21%) and the

UAE (20%). Other distinguishing features of these markets are the initiatives by governments and financial institutions to promote financial education and to offer a broader range of financial products.

II. Basic Concepts of Islamic Finance

The foundations of the Islamic banking is based on the sharing of both profits and losses with clients, the linking of any transaction at a tangible asset, thus ensuring the traceability of financial transactions, prohibition of any activity deemed illegal in Islam such as pornography, weapons or alcohol.

In fact, Islamic finance is based on certain fundamental principles of Islam which are:

A. The Sharing of profit and loss

Sharing "fair" profit and risk between the lender (investor) and entrepreneur (borrower) "whatever the form of financing used" and that under the provisions of *Sharia*,

B. The prohibition of Riba

The prohibition of *Riba* which means increasing the "value" and coincides with two "concepts" of finance, Western: wear and interest rates. "Muslim philosophy condemns any rate of interest it is usurious or not,"

They have in common, respect Muslim ethics in their modes of operation. Indeed, the key objective of the Islamic financial system is to promote, in the current economic environment, a set of financial products that excludes the practice of *Riba*, usury condemned by the Quran as stated in Surah 2 - Al Baqarah (The Heifer), Verse 276: "God will exterminate the wear and grow the aumône. Thus, the Muslim world is built on charity and mutual aid against the *Riba* that is considered an unequal exchange.

According to the texts of the *Sunnah*, the *Hadith* narrated by Ahmad Ibn Hanbal emphasizes the severity of the wear and said: “A dirham of *Riba* is worse than voluntarily consumed thirty six sins of fornication.”

Similarly, the majority of Fuqaha agree on the fact that *Riba* is Income excessive and harmful, except that differences in ideas that arise revolve around the characterization of income as income or *Riba* natural market.

Similarly, the Fiqh Academy of the Organization of Islamic Conference meeting in Jeddah in 1985 states that "*Riba* is not the result of an economic activity based on the creative effort of a surplus of wealth legitimate.»

In this sense, considered *Riba* as illegal income derived from the perimeters of *Halal* and *Haram* defined by *Sharia* law.

C. The ban on investment in Haram activities

The ban on investment in economic activities as *Haram*. The gaming industry, alcohol, armaments, but also in companies that violate the fundamental principles of *Sharia* (e.g. companies with strong leverage).

D. The prohibition of speculation

"The prohibition of uncertainty in terms of a contractual relationship," the Speculation is so sentenced. The prohibition of speculation concerns the condemnation of *gharar* by ethics muslmane. The exchange is in *gharar*.

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E. The prohibition of hoarding

The prohibition of hoarding as it diverts funds from operations productive "Every financial transaction must be backed by real assets,"

III. The Tools of Islamic Finance

Islamic Finance promotes the use of participatory financing techniques, in practise, the financing instruments as Murabaha are preferred and, it represents nearly 60% of Islamic financial activities while Mousharaka and Moudharaba represent less than 20%.

A. The Murabaha (Cost Plus)

It consists of a transaction that requires that the creditor (the bank) buys an asset given on behalf of a customer (the debtor). Thereafter, the creditor sells the asset in debtor basis of payments phased over time or at an agreed price advance between the two.

For credit sales (forward) to a client of an asset that the bank has purchased cash, the recovery of the purchase price will be accompanied by payment of a margin beneficiary who is the remuneration of the service rendered by the bank, the amount is fixed in advance and did not vary during the pad length of time for payment granted.

A. -1 _Salam ("the sale al-Salam)

It is a transaction where the payment is made in cash when the delivery is done in the future. Islamic finance prohibits in principle the sale of a non-existent because it involves chance (*gharar*). However, to facilitate certain transactions, notably in Agriculture, exceptions have been granted. It is used to replace products derivatives such as futures or options.

A. -2 Istisna has

It is a financial contract that allows the buyer to purchase property that is delivered at term. Unlike the Salam, in this type of contract, the agreed price in advance is paid gradually throughout the manufacturing good. The practical details of payment are determined by the terms of the agreement between the buyer and seller.

A. -3 Qard-hasan

The loan is more of a help than a trade credit. This technique is rarely used by commercial establishments. It can be used in specific situations where difficulties of an individual or a business....

B. Moucharakah or association (Joint Venture)

It is an association between two parties who pool their capital financial in nature or humans in an investment project. Profits or losses possible will be distributed proportionately to the capital used by each shareholders or investors. This technique is the most Islamic financial instrument faithful to the tenets of Islam, but in reality it is rarely used.

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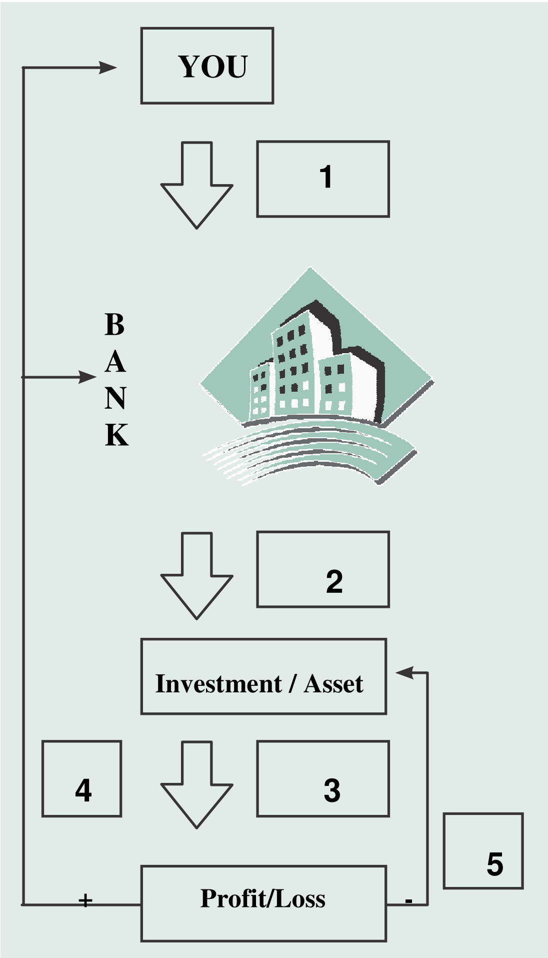
C. The Moudarabah (sharing of profit)

It brings together two parties the investor (the rab al mal) and the contractor (*Mudarib*). The first takes care to provide the capital while the other puts all his expertise and know-how to manage the activity of the investment project that must be *halal*. In case the investment project is profitable, the profit will be distributed between the two parties conventionally (according to an agreed in advance). In Otherwise, it is the investor who bears the entire loss.

Here is how it works:



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D. Ijara (Leasing)

This operation is similar to hire purchase or lease. The creditor (the bank) buys the property he leases to a client with, for one, a possibility of redemption term of the contract. *Ijarah* is normally used in financing consumer goods especially materials or motor vehicles.

Here is how it works:

IV. The *Shariah* board

The *sharia* board is a key element of the structure of an Islamic financial institution, carrying the responsibility of ensuring that all products and services offered by that institution are fully compliant with the principles of *sharia* law. The role of the board also involves the reviewing and overseeing of all potential new product offerings. Additionally, the board may be called on to make a judgment on individual cases referred to it, relating to whether specific customer business requests are acceptable to the institution. Given that *sharia* law is derived from studies of both the Qur'an and the Sunna, inconsistencies can occur in the interpretations of precisely where the boundaries of compatibility lie, with the result that some *sharia* boards may deem unacceptable proposals that may be approved by other boards.

With demand for *sharia*-compliant financial services growing at a faster rate than mainstream banking, the board can also play a vital role in helping to develop new procedures and products to position the institution to adapt to industry trends, and customers' expectations. The board should also be closely involved in overseeing *sharia*-compliant training programs for employees. Board members also participate in the preparation of an annual investors' report on the bank's balance sheet, with particular reference to its compliance with *sharia* principles.

Given the importance of the role of the *sharia* boards in ensuring the conformity of the institution's offerings, boards typically include acknowledged experts, such as contemporary Islamic scholars. It is common for such scholars to sit on the *sharia* boards of multiple institutions; some senior scholars may sit on the boards of 15 or more institutions. The activities of individual boards are supervised by an independent body, the International Association of Islamic Bankers. This association's Supreme Religious Board examines the judgments, or *fatwas*, of individual *sharia* boards to ensure conformity to *sharia* law.

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A- Duties of a Shariah Board

The duties of a *Sharia* Supervisory Board or *Sharia* Committee are to advise and certify in form of a legal opinion (*fatwa*) certain financial products of a financial institution.

The key issues of such a board are laid down in this text: independence of the bank, qualification, bindingness of their decisions towards the bank.

The current understanding of a *Sharia* Board is defined by the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) in Bahrain. This body is built to standardise key practices of the industry. Their definition is as follows:

> "A *Sharia* supervisory board is an independent body of specialised jurists in fiqh al mu´amalat (Islamic commercial jurisprudence). However the *Sharia* supervisory board may include a member other than those specialised in fiqh al mu´amalat but who should be an expert in the field of Islamic financial institutions and with knowledge of fiqh al-mu´amalat. The *Sharia* supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution to ensure that they are in compliance with Islamic *Sharia* rules and principles. The *fatwa*s and rulings of the Board shall be binding on the Islamic financial institution."
>
> The standard definition by the AAOIFI is pointing out the kind of qualification as specialised jurist in Fiqh Muamalat. It further explains the importance of legal analysis for Islamic financial institutions.
>
> After reviewing all the documents, contracts and reviewing them, demanding adjustments and finally agreeing if so agreeable the *Sharia* Scholar is issuing a *Fatwa*, a legal opinion, which is used to advertise it to prospective clients. Such a *Fatwa* is subject to a number of conditions, regarding the prevailing circumstances, which are named, e.g. in the *Fatwa* for the Islamic Bond (*Sukuk*) of the German state Saxony-Anhalt:

- Often a non-Islamic legislation, which cause legal constraints
- The need to further develop the emerging Islamic finance industry as an alternative and viable financing system
- The various existing constraints and restrictions imposed under the various conventional financing techniques available in many Muslim countries
- The prevailing conditions and affairs of the *Ummah* and the need to remove them from the shackles of *Riba*.

B- Certification Process

In order to receive a certificate certain steps are needed to be undertaken. The minimum involved parties are the financial institution, the *Sharia* scholars and as well the institutions law firm drafting the documents and contracts.

The choice of a *Sharia* scholar could be undertaken on a case by case decision for a certain defined product or the financial institutions has appointed a continuous board supervising their Islamic department or in case of an Islamic banks the entire institution. Most of *Shariah* boards consisting of two to three scholars who should be reputated and recognised in the area the product is sold or the institution is situated. The overall number of scholars in the world with the qualification of finance and *Fiqh Muamalat* is analysed by Funds at Work in their study.

The process of certification has a number of loops. Firstly a drafted structure chart will be shown to the *Sharia* Board for an initial indication whether it raises concerns before taking all the time to draft the detailed contracts about it. If so agreed by the scholars, then the law firm

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proceeds in drafting all the documents and contracts to undertake the transaction. All this paper work needs to be read, understood and analysed by a scholar, and he will raise a number of questions and proposes a number of a changes in the wording and content. It then goes back to the lawyer for the necessary changes and could then possibly pass the board, however, the board may ask again for further changes, which put the contract again in the “loop”. This process is one of the reasons which some conventional banks hesitate to create an Islamic compliant product as it slows down of course the time to market.

V. The Tunisian Islamic banking sector

A. The legal framework for Islamic Finance in Tunisia

The Tunisian Islamic banking sector is governed by the law n° 2001-65 of July 10^{th} 2001 relating to Credit Establishments which provides in its article 7 that “everyone who intends to constitute a company, to have an activity of a bank or a financial establishment, must previously to the exercise of his activity in Tunisia get the agreement in compliance with the conditions that are determined by the present law”.

The agreement petition must be addressed to the BCT (La Banque Centrale de Tunisie) which proceeds to its study. In effect, this agreement is given having regard to the program of activity of the requiring establishment, and the technical and financial tools it provides for operating.

Furthermore, article 11 of the same law stipulates that “no opening or closing of an agency in Tunisia or outside may take effect without the prior authorization of the Ministry of Finance and the BCT. In the same meaning, the article adds that only the authorization of the BCT is required for the opening of periodic offices.

In fact, there is no specific Agreement that is given to Islamic banks. The unique existing agreement according to the indicated law is a universal agreement which requires the Islamic bank to submit the petition and to obtain this agreement before specializing in the activity of Islamic bank.

As a matter of fact, and following their chronological order, we can cite the following Examples of Tunisian Islamic banks:

B. Examples of Islamic banks in Tunisia

B.1 The BEST Bank or Al Baraka Bank

Founded in 1983, and a pioneer of Islamic finance in Tunisia. **The Best Bank** renamed the **Al Baraka Bank Tunisia**. The latter has obtained authorization under the law n ° 85-108 of 06/12/1985 on encouraging financial and banking working mainly with non-residents, repealed by the code of financial services to non-residents in August 2009.

The above mentioned law provides in its article 3 that the non-resident establishments must get the agreement of the Minister of Finance which is delivered after consulting the National Council of Credit, on a report of the BCT.

This is an offshore bank wearing a strand of activity for residents and non-residents. "It's almost the offshore bank that has most contributed to the financing of the economy.

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B.2 Zitouna Bank

Tunisia has launched the first Islamic bank, Zitouna Bank, in the Maghreb (North Africa) with capital of $30 million to reach 71 million by 2012 to develop Islamic loan and saving products for businesses and individuals..

Governed by Law 2001-65 of 10 July 2001 relating to credit institutions, the Bank Zitouna is subject to the same rules as traditional banks and the control of the Central Bank of Tunisia. Islamic banks do not receive any special treatment. They are thus subject to the same regulations of the BCT, the same rules of good governance and disclosure of documents that other banks instead. Indeed, laws specific to these banks therefore do not exist.

All provisions relating to 'Islamic products "are also defined in the Code of Obligations and Contracts (COC). After the entry into operation of the Zitouna Bank at the end of May 2010, the Tunisian banking landscape has been enhanced with new products based on the principles of Islamic finance. In effect, the opening of the Zitouna bank has proved to be a successful achievement having regard to the number of its clients which is growing since that date with a capital of 25 million dollars to reach 71 million dollars in 2012.

The bank is starting with nine branches and managers will grow to 20 in 2011. The Bank, which will operate in compliance with the Tunisian laws in force in matters of finance, will offer thirty new products, he pointed out, adding that this institution will open 4 agencies at a first stage before reaching out to the regions with other subsidiaries.

The objective is to reach 5% of market share in the short term and reduce traditional services (performed manually), to promote administrative services, which are capable of mastering both the taxes and risks.

Sharia-compliant finance bans the receipt of interest and investments in companies dealing in alcohol and gambling. The global industry is estimated to be worth around $1 trillion, according to sector analysts.

It is worth mentioning that Tunisia authorised Islamic finance in 2007, partly to channel more investment into their fast-growing tourism and real estate industries.

B.3 Noor Islamic Bank

The Islamic Bank "Noor" opened in Tunisia; it is the first office of representation of the Bank outside Arab Emirates has for an objective to offer bank services to the benefit of North African countries. Islamic Bank "Noor" aims at reinforcing the cooperation with North Africa in general and Tunisia in particular and to profit of strategic investment opportunities offered by the region, in order to reinforce the reputation of the Bank as a supplier of financial solutions.

C. Perspectives of Islamic Banking and Finance in Tunisia

The Governor of the Central Bank Taoufik Baccar, during a meeting with journalists, and in response to a question about the possibility of entry of new Islamic banks in the Tunisian market, stressed on the fact that the granting of approval for the performance of the banking business is governed by the legislation regulating the profession and the code of contracts and obligations.

Therefore, if the legal conditions required for the creation of such type of credit establishments are gathered, then nothing in principle would prevent the creation of more and

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more Islamic banks in the Tunisian market so that to enhance and promote their activity and competition, or the conversion of certain existing conventional banks to the Islamic Banks system with all its tools, concepts, principles and operational manner.

However, in the absence of a precise legal framework to confirm this ability and authorize this conversion, the answer to this question remains an opened perspective capable of being confirmed in the next coming years.

VI. Future issues to examine

1-The lack of human capital is a key constraint to the development of Islamic finance since the need of qualified managers in the banking techniques and having knowledge of standard Muslims' contract law.

2-The linkage between finance and religion that includes the Islamic finance also raises questions about its ability to integrate innovation and adapt to changes in demand for financial products.

3-The attention is now directed towards Islamic products. The basic principles of Islamic finance would have avoided the global crisis. Globally, "Islamic banks, unlike their conventional counterparts, have shown a certain stability and resistance to crisis."

4-Shall the Islamic financial institutions adopt the same regulatory framework than their conventional counterparts, or is it time that the authorities develop specific rules in Islamic Banking?

5-The need for all necessary audit and accounting tools to govern Islamic Finance based transactions.

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