DEVELOPING A SUSTAINABLE ISLAMIC BANKING INDUSTRY IN OMAN

SHAPING THE FUTURE OF THE ISLAMIC FINANCE INDUSTRY

Muscat Oman March 23, 2014
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1 | Opening Remarks by Mr. Sulaiman Al Harthy, Group GM of Islamic Banking
2 | Presentation by Dr. Sayd Farook, Global Head Islamic Capital Markets, Thomson Reuters
3 | Opening Ceremony with Chief Guest HE Sheikh Abdullah Al Salim
4 | Islamic Finance Vision: Charting tomorrow’s path for sustainable growth in Islamic finance — Abdulhakeem Alkhayyat, Managing Director & CEO, Kuwait Finance House Bahrain.
ATTENDEES BY JOB POSITION

- 60% C Level
- 18% Finance Professionals
- 16% Others
- 3% Investment/Treasury
- 3% Advisors/Consultants

ATTENDEES BY COUNTRY

- 88% Oman
- 7% UAE
- 3% Bahrain
- 2% Others
- 3% Others
Oman was the last of the GCC countries to introduce Islamic banking. A year following the opening of the first Islamic banks in the sultanate, Thomson Reuters, in partnership with Meethaq, held a seminar to assess the state of Oman's Islamic banking sector and map the way forward for the sustainable development of the industry. The seminar was attended by finance professionals as well as representatives from Oman's central bank, Capital Market Authority and Ministry of Finance. Three sessions were convened that concluded the following:

**Near term pressure on profits, but inherent long-term potential**
Underlying consumer preference for Islamic products, particularly from stand-alone Islamic banks, is strong according to an IFAAS survey conducted in 2011. While growth has been slow in the first year compared to what one panelist said were "unrealistic expectations", panelists expressed optimism that Islamic banking could end up with a majority share of banking assets. The growth will depend on meeting consumers' demand for authentic sharia-compliant products that are priced in line with conventional banking products. Islamic banks face a challenging situation in the early years when they must generate profits for depositors while also investing in the development of a broad offering of Islamic financial products.

**Final regulations for sukuk and sovereign issuance will spark issuance volume growth**
The sukuk markets in Oman will have to develop without a vibrant bond market to guide pricing and without an established sovereign issuance program to provide a yield curve. Issuers will want to speed up issuance process at a time when there is cheap and easily accessible bank financing. Foreign investors are eagerly anticipating Omani sukuk since the country is viewed as a 'safe haven', but will face an illiquid market with few sukuk in the early years.
There are many possible alternatives to tawarruq and introducing them in Oman could lead to wider adoption of successful products

Thomson Reuters’ Islamic Finance Gateway suggested three alternatives to engage the discussion:

1. Qard-based lending with funds held under an amanah (safekeeping) agreement where the central bank tallies points for lending (positive) and borrowing (negative) with the requirement that the balance cross zero every 90 days to continue participating.

2. Central bank maintains a book of sovereign and GRE USD sukuk from foreign issuers and issues short-term wakala or mudaraba certificates based on this pool where the central bank benefits from the possibility of gain from the higher yield on longer-tenor sukuk (offsetting some of the credit risk assumed) while the Islamic banks would gain short-term tradable assets with a sovereign guarantee.

3. Banks and central bank enter into a musharaka agreement where the bank contributes sukuk and the CBO contributes cash to provide funding to the Islamic bank with specified tenor and anticipated profit rate.

THE RECOMMENDATIONS FROM THE EVENT ARE:

• Islamic banks should jointly fund training for staff of Islamic banks and Islamic banking services

• The CBO should develop a 5-year strategic plan for Islamic finance in Oman

• Islamic banks should develop a committee to engage with the CBO on regulatory issues

• Government of Oman should develop regular issuance of sukuk to develop market & fund deficit

• CBO/Government of Oman should develop short-term sukuk for liquidity management

• CBO/CMA should finalize sukuk rules

• CBO should consider whether tawarruq could be allowed under IBRF with restrictions on use to inter-bank liquidity management & with oversight relating to use of proceeds
1. Islamic banks should jointly fund training for staff of Islamic banks and Islamic banking services
Consumers of Islamic banks have indicated their unwillingness to pay more for Islamic banking services and they expect front-line staff to be capable of explaining sharia basis for product compliance. This requires additional training that will raise costs and so banks should collaborate to provide training for front-line staff.

2. The CBO should develop a 5-year strategic plan for Islamic finance in Oman
Panelists were in general agreement that the CBO needs to lead from the front and guide the medium-term development of Islamic banking and finance in Oman with a clear guide to where it sees the industry in the next 5 years. This will provide clarity on the future direction of regulations relating to the Islamic finance industry.

3. Islamic banks should develop a committee to engage with the CBO on regulatory issues
Islamic banks see the 5-year strategic planning process as an opportunity to engage with CBO and other regulators to bring issues to the attention of the government without having to wait for the problem to linger. The discussions will help fix legislation/regulation where needed and to guide longer-term strategic priorities of the CBO with regards to Islamic banking.

4. Government of Oman should develop regular issuance of sukuk to develop market & fund deficit
The sukuk market will gain a pricing benchmark and Islamic banks will gain a yielding safe asset to invest their excess liquidity. The government will be able to tap a domestic source of liquidity to fund the projected budget deficit which is expect to grow in the coming years. This represents a win-win for both industry and government.
5. **CBO/Government of Oman should develop short-term sukuk for liquidity management**

In addition to the pricing benchmark provided by a longer-tenor sukuk, short-term sukuk issued by the MoF or CBO would provide a safe asset for liquidity management that could be integrated with other ideas for liquidity management tools discussed by panelists and delegates.

6. **CBO/CMA should finalize sukuk rules**

The regulatory uncertainty from the lack of finalization of draft sukuk rules has hampered the development of sukuk markets and led potential issuers to delay considering sukuk. This is to the detriment of Islamic banks that could invest in such instruments as well as foreign investors who want to see a critical mass of sukuk offerings before entering the market.

7. **CBO should consider whether tawarruq could be allowed under IBRF with restrictions on use to inter-bank liquidity management & with oversight relating to use of proceeds**

Panelists and delegates were divided on whether a limited form of tawarruq should be used to fill the liquidity management product gap. Some panelists argued that in limited cases like inter-bank liquidity management, there are no other viable products or insufficient availability of these alternative products. Other panelists suggested that imposing limitation on the use of proceeds by lending banks where these are conventional banks to limit leakages into non-sharia-compliant could allow these products to exist without overly diluting the Islamic Banking Regulatory Framework. Panelists were in general agreement that any allowance for tawarruq should be limited to inter-bank financing and not be extended to consumer/non-bank corporate financing.
Consumer surveys consistently indicate strong retail market potential for Islamic banking in Oman. In an already competitive market however, is there space left to profitably sustain the operational costs of operating another Islamic banking business? Is it worthwhile exploring full conversion to Islamic banking rather than opening dedicated windows? How can Islamic banks differentiate themselves? What are customers looking for beyond sharia-compliance in Oman?

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Shaheer Abbas
Director of Shariah Compliance & Product Development, IFAAS
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2 | Mohammed Nadeem Aslam, Head of Islamic Banking, Bank Muscat Meethaq
3 | Shaher Abbas, Director of Shariah Compliance & Product Development, IFAAS
4 | Sohail Niazi, Chief Islamic Banking Officer, Bank Dhofar.
It is too soon to judge the success or failure of Oman’s Islamic banking industry after just a year. The market is still in the early stages of development but there is significant potential based on underlying consumer preference for Islamic products, particularly from standalone Islamic banks. Panelists did not just anticipate significant growth in the next five to ten years, but expressed optimism that Islamic banking could end up with a majority share of banking assets. Consumers demand authentic sharia-compliant products, are knowledgeable about what they want and are not willing to pay significantly more for Islamic banking products. This puts Islamic banks in a challenging situation in the early years when they have to find ways to generate profits for depositors while investing in the development of a broad offering of Islamic financial products.
The seminar began with an overview of the results of a first-of-its-kind Oman market research survey conducted in 2011 by the Islamic Finance Advisory & Assurances Services (IFAAS). The first result presented by IFAAS’ Shaher Abbas was the finding that Omani consumers had a strong preference for Islamic banking with 85% reporting they were interested. However, perhaps as a result of coming later to the market and seeing the development pathway in other countries, Omani consumers indicated they would likely take a wait and see approach and remain in their conventional banking relationships to see how the Islamic banks develop.

These survey results have been borne out in the industry development as growth was lower than what one panelist called ‘unrealistic expectations’ for growth. Consumers are not willing to accept the products as being sharia-compliant based on the bank presenting them a fatwa, but want to have the front-line staff be able to answer their questions about sharia-compliance, which could increase costs. The additional costs—an issue well-known from experience in other markets—combines with the reticence of consumers to change their banks and the limited product offering to limit the immediate growth potential for Islamic banks, while also favoring Islamic banking services connected to existing conventional banks, a market where Bank Muscat and its Meethaq Islamic banking service has a strong advantage and large market share.

This market share is bolstered by Meethaq’s Islamic banking services that have had four years of mortgage product experience before the implementation of the Islamic Banking Regulatory Framework (IBRF). During this period, Meethaq was not able to use the ‘Islamic’ label and relied upon word-of-mouth. In building its RO150 million (approximately USD$390 million) in assets, it was able to attract relatively price insensitive customers, while now consumers demand not only reasonably priced financing, but also a similar product offering as conventional banks. IFAAS found that nearly four in ten (37%) would not pay any premium for Islamic banking while 29% more would not pay more than RO10 per month on RO100 in financing.

Panelists’ experience in line with the survey results confirm that customers are entering the market with more literacy about Islamic financial products, but want to easily compare conventional and Islamic products when they decide whether to use Islamic or conventional banks. Initially banks may be able to look towards the 10-20% of consumers who are currently unbanked or place an
extremely high importance on sharia-compliant banking services, but the rest of the Omani population—99% of whom are Muslim—are educated, discerning consumers who are not willing to sacrifice pricing or product offerings just to use an Islamic bank.

**CHALLENGES FACING ISLAMIC FINANCIAL INSTITUTIONS**

As a result of the consumer expectations about pricing, product offering and front-line employees who can explain why a product is sharia-compliant, there may be a challenge in getting Islamic banking established, even if the longer-term picture is bright. Banks will face higher costs for staffing and training, as well as additional costs for Islamic banking services to establish separate windows. One panelist added that the conventional banks offering Islamic banking services are not always motivated by growth potential but by a need to prevent customers leaving.

As a result, there is market segmentation between the larger banks which can take advantage of scale economies in their Islamic banking services as a result of using existing infrastructure (technological systems, existing branch network where branches can be converted to serve Islamic banking customers, etc). The smaller conventional banks with Islamic windows will not be able to benefit from these advantages and will likely see higher costs to maintain with the "onerous" rules on segregating funds within conventional banks and their Islamic banking services.

Standalone Islamic banks will have the advantage of avoiding the segregation of funds rules, but will have to develop internal infrastructure from scratch and will be less competitive on pricing, even though IFAAS found that nearly three-quarters (73%) would prefer a standalone Islamic bank.

Outside of retail banking, Islamic banking services connected with conventional banks may have an advantage as the corporate banking market relies more on relationships, product development (using lessons learned on the conventional banking side) and knowing customer needs from long-term banking relationships. The growth in this area is likely to emerge from economic growth, which is in large part due to infrastructure projects. Some of the financing opportunities in infrastructure will have to be carved out of larger deals than the Islamic banking service alone could sustain.
A significant amount of the discussion was concerned with the long-term prospects for the Islamic banking industry in Oman and participants were in agreement that it is too soon to judge the success or failure of the industry after just a year. The bigger question was how it would fit into the economy—valued at RO30 billion and growing between 4–4.5% a year—and within a banking sector growing faster than the overall economy (8–10% per year).

One of the driving forces supporting higher market share for Islamic banking is demographic with half of the population aged under 28 and younger consumers expressing a stronger preference towards Islamic banking than their parents and grandparents. The short-term headwinds from a wait and see approach by consumers, higher costs for Islamic banking, a more limited product offering and limited liquidity management products are slowing the growth at an early stage. However, some of the growth will be easier than in more mature markets where bank assets represent a much larger (and growing) share of GDP (Oman’s is the lowest in the GCC which itself has lower banking penetration than developed markets).

Yet the panelists were not just anticipating significant growth in the next five to ten years, but were expressing optimism that Islamic banking could end up with a majority share of banking assets. The closest analogue to panelists expectations is Saudi Arabia where demand from consumers buoyed the market share of Islamic banks and windows. With the Islamic banking services growing rapidly in the kingdom, some banks realized that they could reach more of the market at lower cost if they eliminated their conventional banking services, and some panelists expected similar developments in Oman.

One area of significant concern is in the Central Bank of Oman’s role, which several panelists complained was not forward thinking enough. The panelists agreed that more interaction between the CBO and industry would be beneficial. This suggestion was linked to demand for a 5-year strategic plan to be drawn up by the CBO. However, despite these complaints, panelists did highlight the significant accomplishments from the first year of Islamic banking in Oman and its late entry into Islamic banking allowed it to incorporate international best practices into its regulatory system and even begin to lead in some areas like external sharia audits and restrictions on tawarruq. ■
CAPTURING THE OPPORTUNITY: SUKUK AS A CATALYST FOR FOREIGN INVESTMENT IN OMAN

Oman ranks highly with sukuk investors when asked where they would like to channel their foreign investment. Sukuk offers local investors and financial institutions added portfolio diversification and investment opportunities in the form of new asset classes, whilst issuers can benefit from increased liquidity by tapping into the growing demand for sharia-compliant investment products. Yet, awareness of the investment sourcing potential has not fully developed among corporates, while regulators are proactively trying to enhance the regulatory framework to support issuance.

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6. Tariq Khan, Head — Corporate Finance & Advisory, Bank Muscat Meethaq.
Rules governing Oman’s sukuk markets are still in development but even without these, there has been one sukuk issue in Oman, as of this writing — a 5-year RO50 million (USD$130 million) sale issued by property developer Tilal in November 2013. The sukuk markets in Oman will have to develop without a vibrant bond market to guide pricing and without an established sovereign issuance program to provide a yield curve. Issuers face a decision between a potentially lengthy issuance process to raise money via sukuk in an environment where there is cheap and easily accessible bank financing. Investors face an illiquid market with few sukuk to invest in which makes it more difficult for domestic and foreign investors to get sufficient diversification in the market.
MARKET INFRASTRUCTURE AND POTENTIAL

Oman ranked fifth overall in the ICD Thomson Reuters Islamic Finance Development Indicator (IFDI), and was one of the new markets considering sukuk that received the highest interest in the Thomson Reuters Zawya Sukuk Perceptions & Forecast 2013 report. The conventional bond market in Oman is limited which in other situations has made it more difficult for a sukuk market to develop. Notably missing is a vibrant government securities market, which provides the basis for corporate issuance and also makes the market more attractive to international investors.

The bank lending market is competitive, and the industry’s desire to retain assets in addition to a conservative government approach towards debt (which has trickled down through government-related entities into the corporate sector) has put Oman’s debt capital markets in the position of being less than one-eighth the size of the Muscat Securities Market total market capitalization. Most countries see the reverse with debt markets many times larger than equity markets.

An emerging catalyst for sukuk markets is an announced sovereign sukuk which will provide the initial point on a benchmark yield curve, particularly if it is followed with other offerings at the same and other tenors. The lack of a sukuk is particularly challenging for Islamic banks with excess liquidity that they cannot place with conventional banks since they are prohibited from using tawarruq.

ISSUER PERSPECTIVES

The rules governing the sukuk markets are currently in development with the Capital Markets Authority (CMA) and Central Bank of Oman (CBO) and panelists called for them to be finalized, even if they are not perfect because changes can be made once they are rolled out and issuers begin issuing sukuk.

As the Tilal sukuk demonstrates, it is possible for issuers to tap the market even without rules, but that sukuk was delayed by the lack of regulatory clarity and there are many other issuers who will wait until the rules are issued to come to market. Even when the rules are finalized issuers will confront challenges in choosing between cheap and readily available liquidity from more familiar bank sources, which contrasts with a lengthy process for sukuk and
challenges pricing the sukuk given the lack of government yield curve to use as a benchmark.

Once issuance does commence, the most likely issuers are from the infrastructure space (electric, oil & gas, telecom) with projects that have large financing requirements in USD that are too large for the banks to finance (leading project managers to use international banks instead). USD financing is preferred in many cases because infrastructure projects must frequently pay contractors in USD.

The banks will wait until there is clarity on taxation and enforcement, something which will become clearer once the final rules are released. Bank Muscat jumped ahead of this process by announcing a RO500 million (USD$1.3 billion) program though it has not yet issued any sukuk. Some of this program could be issued in USD to finance projects where there is not enough domestic capacity for USD project financing. The remainder will be local currency sukuk in order to improve the structure of the balance sheet and lengthen maturity profiles to account for faster growth in assets than deposits.

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**INVESTOR PERSPECTIVES**

Fixed income investors have been seeking exposure to Oman’s economy which has been very difficult so far as banks work to hold onto assets. Investors view Oman as a safe-haven and are interested in putting lots of liquidity into the market if there were a way for them to do so. However, for Oman’s market to appeal to foreign investors, it has to reach a critical mass of issues to allow for investor diversification. Investors are looking for exposure to the economy and want something that is easy and that they understand (rated, USD sukuk being their ideal investment).

In addition, the lack of final regulations for the sukuk market hampers their willingness to invest. While the draft rules have adequate investor protections and require proper corporate governance to verify performance and compliance with financing terms, they are not yet final. The choice of law is not as important for investors in sovereign issues because they understand that they have sovereign exposure, but corporate investors prefer offshore SPVs with English law. It is not yet clear whether they will accept the use of PGCs (onshore Omani SPVs), which is an improvement on the situation in the Saudi Arabian market where only offshore SPVs are possible for sukuk.
In terms of the types of investors that are likely to participate in the sector, one panelist cautioned issuers to learn from the example of the SABIC retail sukuk which sold well but was met with investor disappointment when they received coupons much lower than the dividends paid to equity investors in the company. The panelist added that bonds are generally best when sold to the wholesale market with retail investors picking up exposure through sukuk funds.
Oman's prohibition of commodity murabaha in almost every instance poses challenges to its nascent Islamic finance industry but, at the same time, drives innovation and the continuing search for more 'authentic' liquidity management solutions. In an interactive session, panelists and delegates explored new liquidity management products to fill the yield curve.

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Mohammad Haris
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6 | Muhammad Riza, Head of Treasury, Oman Arab Bank.
The final session was an interactive discussion among event delegates and panelists with assistance from the CBO and Ministry of Finance (MoF). Islamic banks were set up with the required capitalization and have only recently been able to deploy assets into profitable instruments. As a result, the current need is much more on finding ways to deploy excess liquidity. However, the products needed should also allow Islamic banks to access/invest in daily or weekly instruments in their asset-liability management. Any product should also be eligible for use in reverse repo transactions with the CBO.

The CBO requested submissions from six consultants and has received comments from Islamic banks. It is currently in the process of finalizing the ideas to ensure they are practical for business and also ensure fair treatment of Islamic and conventional banks. They are expected to be finalized by Q2/Q3 this year. The Islamic banks in operation for the first year have worked together to develop an inter-bank wakala network for short-term placements of excess liquidity and accessing inter-bank liquidity by shortfall banks. The challenge in the inter-bank market arises from the excess liquidity at most of the existing Islamic banks, although to some degree this is mitigated by Meethaq’s position (as the largest Islamic banking service) at the end of 2013 as a net borrower of RO200 million, which gives other banks a source of profitable return on their excess liquidity.
SUGGESTED SOLUTIONS FOR LIQUIDITY MANAGEMENT

Thomson Reuters Islamic Finance Gateway suggested three alternatives to engage the discussion:

1. The first would encourage qard-based lending with funds held under an amanah (safekeeping) agreement. The CBO would monitor various exposures and each bank would receive points for lending (positive) and borrowing (negative) with the requirement that the balance cross zero every 90 days to continue participating. One panelist was concerned that this system would replace the market-based wakala financing and that it would be better to perform bilateral qard loans with the central bank under the same terms. The panelist suggested starting with a 1-week term for the CBO to evaluate whether it would work to have the CBO placing funds with banks, while another panelist suggested the CBO-placed funds would likely end up flowing offshore given the excess liquidity at Islamic banks and windows.

2. The second idea would be for the CBO to maintain a book of sovereign and GRE USD sukuk from foreign issuers and then issue short-term wakala or mudaraba certificates based on this pool. A panelist from the CBO did not say whether it would consider such a policy, but there are concerns about whether the CBO would be in the position and willing to accept the credit risk associated with the pool. In this proposal, the CBO would benefit from the possibility of gain from the higher yield on longer-tenor sukuk (offsetting some of the credit risk assumed) while the Islamic banks would gain short-term tradable assets with a sovereign guarantee.

3. In contrast to the two ideas, the third proposal touched only on the liquidity demand side (it would not absorb liquidity). The bank and the CBO would enter into a musharaka agreement where the bank contributes sukuk and the CBO contributes cash to provide funding to the Islamic bank with specified tenor and anticipated profit rate. At the conclusion, the bank would return the cash and profit and the partnership would end with a distribution of the cash to the CBO and a return of the collateral to the Islamic bank.
OTHER IDEAS FOR LIQUIDITY MANAGEMENT

1. Panelists also suggested other ideas including to study the usage of short-term sukuk issued by the central bank with the Central Bank of Bahrain acting as the prime example (CBB issues 3- and 6-month salam and ijara sukuk, respectively, through monthly auctions).

2. Another panelist suggested considering joala such as that has been used by the central bank in Indonesia. It is designed to mop up excess liquidity from the market; the central bank issues a request for funds and specifies a payment if a certain volume is tendered. One disadvantage in this contract is that it is not tradable and so the bank has no option to monetize the receivable during the 9-month tenor used in Indonesia (where it has since been replaced by tradable project-based sukuk).

3. Other ideas included allowing the CBO to act as agent for the banks to invest in MoF projects where the returns are paid to the Islamic banks (less a fee for the CBO acting as agent). However, this was criticized by panelists as a synthetic alternative that would be useful to help provide profitable investments for the estimated $2 billion in surplus liquidity.

4. Another more contentious idea proposed by panelists was to lift the blanket prohibition on tawarruq transactions. A panelist suggested that while tawarruq was not necessary for consumer financing, it could be the only workable alternative for some inter-bank transactions. This could be the case, for example, where banks do not have sufficient assets available (or counterparties willing to engage) in wakala transactions.

The discussion on tawarruq proceeded to examine potential requirements that would remove some of the more problematic aspects of the contract when the counterparty is a conventional bank. One idea was to have the CBO manage the allocation of interbank transactions on a randomized basis (which is used in Indonesia) to reduce counterparty risk while avoiding cases where the buyer and the seller were the same institution.

Other panelists countered that there is a large enough pipeline of sukuk that this would be an unnecessary weakening of Oman’s strong regulatory framework that leads the way in restricting tawarruq.
5. Another idea presented was ways that the CBO could relax other rules including foreign holdings and limits on holdings of government-issued sukuk. Elaborating on the latter idea, one panelist suggested that Islamic banks should have a first right of refusal for government sukuk to ensure their access to supply and provide demand from other parties in secondary markets.
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