

What is Islamic Finance?

The basis of Islamic Finance denounces usury, termed as **riba** (which is the lending of money at exorbitant rates) but it doesn't stop just there. The concept is more accurately that money has no intrinsic value – it is only a measure of value, and since money has no value itself, there should be no charge for its use. Therefore, Islamic Finance is said to be **asset based** as opposed to **currency based** whereby an investment is structured on exchange or ownership of assets, and money is simply the payment mechanism to effect the transaction. The basic framework of an Islamic Financial System is based on elements of **Shariah**, which governs Islamic societies. Shariah, the law of Islam, originates from two principal sources: the Quran, the Holy Book of the Muslims and its practices; and the **Sunnah**, the way of life prescribed as normative in Islam, based on the teachings and practices of Prophet Muhammad (pbuh).

When did Islamic Finance start being used?

As mentioned, the basis of Islamic Finance is from the Shariah, so the concepts of Islamic Finance have been around since the origination of Islam itself. The practices of what we see today have been used throughout the last 1500 odd years across the modern Muslim world and beyond. The modern Islamic finance really originated in the 1960s, escalating with the petrodollar boom of the 1970s when in 1975, the [Islamic Development Bank](#) was formed to promote acceptable financial practices according to Islam. While many banks originating in the Middle East strictly follow these principles, many also follow Western practices of finance, with a number following both practices to cater for both markets. Interestingly, many of the international larger banks (with [HSBC](#), [UBS](#) and [Citigroup](#) as notable examples) all have **Islamic banking** arms, both in the Middle East and the West.

What are the main principles of Islamic Finance?

The main principles of Islamic Finance include:

- The prohibition or taking or receiving interest at exorbitant rates (Riba), but this does not preclude a rate of return on investment which is agreed up front by both parties contracting. In most cases, the references to interest rates by Islamic financial institutions are to help benchmark the return on investment to offer transparency. This does not imply interest is being used in the transaction.
- Risk in any transaction must be shared between at least two parties so that the provider of capital and the entrepreneur share the business risk in return for a share in profit.
- The prohibition of speculative behaviour (Gharar), meaning that gambling (Maysir) and extreme uncertainty or risk is prohibited and thus contractual obligations and disclosure of information are a sacred duty.
- Investments that violate the rules of Shariah, advised against by Shariah boards, and are generally non-ethical meaning that investment in businesses related to alcohol, pork related products, conventional financial services, entertainment (gambling and casinos, pornography, weapons and defense. An example of index restriction can be seen on [Page 5 of the Dow Jones Islamic Market Index Rulebook](#).

What are the reasons for the recent growth in Islamic Finance?

The IMF published an article in 2008 which estimated that there are now more than 300 Islamic financial institutions operating in more than 75 countries at the end of 2007. With the industry sector maintaining a growth rate of 15% per annum over the last 10 years, it is predicted that this growth will continue or speed up in the coming years, dependant on different regulatory practices. The main reason for the growth stems from a number of sources:

- Muslims worldwide are starting to opt for Shariah compliant products that were not previously available to them;
- The increase in oil wealth of the Muslim nations in the Middle East and their decision to opt for Shariah compliant structured investments is making the western governments and conventional financial institutions consider using Islamic Finance
- Due to their increasing competitiveness and ethical focus, Islamic products are attracting both Muslims and non- Muslims.
- With Islam as the fastest growing religion in the world, and being the second largest religious group in the UK, USA and France, Islamic Finance is certainly not about to go away any time soon.

What are the more common instruments offered by Islamic Finance?

With the prohibitions dictated by Islamic Finance, the method to undertake transactions differs, in concept, to Western philosophies. The main instruments are:

Shariah compliant Current and Saving Accounts

In the absence of interest, there needs to be some incentive to gain a customer and this is done through a profit sharing exercise whereby at the end of the year, banks allocate profit to the account holders, which may be equivalent to, but not the same as, a conventional saving rate. In the UK, the Consumer Credit Act requires all lenders to show a comparative rate of interest to comply with the Consumer Credit Act 2006 (CCA). Often the sight of an interest rate is misunderstood as trading in interest when in reality it is only used as a benchmark and to comply with the CCA.

Also, since an overdraft facility would amount to charging interest, banks may offer interest free loans (Qard- Hassan) in certain cases. This is not obligatory on the bank as it has to ensure it keeps a commercial viewpoint on its trading operations. Consider this, if an Islamic Bank offered Qard Hassan to all its customers, there would be no trading profit to pay its operating costs and share of profit to its depositors – the bank wouldn't be in business for very long.

Murabaha (Cost-plus sale)

Murabaha essentially is undertaking a trade with a markup and is used for short-term financing, similar in form to purchase finance. An example would be a bank purchasing a tangible asset of some sort from a supplier with the resale based on the cost plus an agreed markup. This is most often used to finance property, since the bank would not be allowed to charge interest on any

loan. Once such a debt covenant is in place between a bank and the customer, repayments can begin until a completion point where the asset is transferred to the customer. There is no exposure to variations in interest rates as there is a fixed markup percentage, identified at the outset.

Ijara (Leasing)

Ijara is a leasing contract whereby one party leases an asset for a specific amount of time and cost from another party, usually a bank. The bank would bear all the risk and a portion of the installment payment goes towards the final purchase of the asset at the time of transfer of asset. This can also be set up as a lease-purchase contract for the term of the asset's specified lifetime.

Musharaka (Equity Participation)

There is very little difference between this and a joint venture agreement. The parties involved contribute in varying degrees of assets, technical expertise etc. and agree to a percentage of the returns as well as the risk. All parties must invest a certain amount of capital. In the case of purchasing a property under this sort of arrangement, it is purchased by both the bank and the customer together, and the repayments made are partly rent and partly a buyback.

Mudaraba (Partnership Financing)

Mudaraba is very similar to Musharaka and is a trustee type finance contract under which one party provides the labour while the other provides the capital.

Istinaa (Commissioned Manufacture)

Istinaa is the solution for manufacture of goods since speculation prevents the selling of something that one does not yet own. With a promise to produce a specific product that can be made under certain agreed specifications at a determined price and on a fixed date, an Istinaa contract is established. Specifically, in this case, the risk taken is by a bank that would commission the manufacture and sell it on to a customer at a reasonable profit for undertaking this risk.

What exactly is the difference between Islamic Finance and Conventional Finance?

If we took the example of purchasing a property again, it could be done in three possible ways – Musharaka, Murabaha and Ijara. The payments might be the same for all these processes as well as for the standard western practice of payment of interest used commonly for mortgages. The difference is that the rate of return is based on the asset transaction and not based on interest on money loaned. The difference is in the approach and not necessarily on the financial impact. Some consider this as just a play on words but to Muslims there is **an inherent difference in the way the transaction is carried out**, and all based upon the previously mentioned prohibition of Riba. The intention is to avoid injustice and unfair enrichment at the expense of another party.

Does this mean that equities, bonds and insurance are unacceptable under Islamic Finance principles?

Equity investing is permissible, so long as the company being invested in does not engage in the prohibited practices mentioned previously. Conventional bonds are considered as Riba and thus not allowed. Instead there exists **Sukuk** (Islamic Note), which is an Islamic type of bond secured on assets and not debt. In general terms, the transaction is structured on an asset base, and so, if a series of payments arise from an asset based transaction, these can be traded at a market price.

The issue with conventional insurance is its interest based nature, the uncertainty of returns and removal of risk from one party to another. Instead, **Takaful** (mutual insurance) is based upon the notion of shared responsibility and provides for shared financial security, so that, in theory, members contribute to a pot, not for the result of profit, but in case one of the members suffers misfortune in their investments. Takaful is thus not based on gaining interest, but really to insure against any losses incurred. 2008 saw the launch of the UK's first Takaful company and there is expectation of more to follow.

Are there any notable examples of use of Islamic Finance?

A recent example of Islamic Finance was the funding of the Dubai Ports World takeover of P&O which, at USD3.5bn was the largest Sukuk in the world and the largest Islamic finance transaction to date.

[Emirates Airline](#) regularly uses Ijara to finance its fleet expansion. Also, banks such as [HSBC](#), Lloyds TSB, are two notable global banks offering Islamic Finance products to retail, commercial and financial market clients.

What is a Shariah Board?

A Shariah board can be thought of as **a committee of a minimum of 3 Muslim Scholars, acting as an advisory board** which issues a ruling as to whether a particular undertaking is in accordance with prescribed principles. What essentially this means is that the board look into specific investments and decide if the investment or process follows Shariah guidelines or is halal (permissible, as opposed to haram meaning forbidden). Some think of it as a sort of due diligence for the customer. Others consider the board to be similar to compliance officers so that they do not have to worry that the investment follows the guidelines of Islamic Finance.

Shariah Boards for different companies will usually have different Scholars. However, the Shariah board consists of those that are knowledgeable in Shariah principles, either from economic, legal or religious standpoints and when working in the finance field, they will usually have Fiqh-al-Muamalat knowledge and experience. They will also usually be members of either AAOIFI (Accounting and Auditing of Islamic Financial Institutions who are based in Saudi Arabia) or IFSB (Islamic Financial Services Board who are based in Malaysia).

Why would non-Muslims use Islamic Finance?

It would seem obvious why Muslims would use Islamic Finance, but realistically, Muslims are only now being able to get the opportunity to do so, and while not all Muslims would necessarily shift, there is growing popularity. What is surprising is the growing number of non-Muslims taking up Islamic Finance. In the UK, Salaam Insurance, the UK's first Takaful company, has a significant part of their customer base made up from non-Muslims. This is in large part due to the conventional pricing of the product range but also due to the ethical nature of Islamic Finance itself. If products are developed using Islamic principles along with a Western approach, Islamic Finance could become an even more significant market over the coming years. After the impact of the excesses and greed by conventional banks in the run up to the credit crunch, the public, governments and financial institutions are all looking for a better way of managing money and a

fairer way of wealth distribution – Islamic finance is one such way as long as it can stay true to its principles.

What are the future challenges?

As Islamic Finance becomes more and more mainstream, there will be a need for further regulation at different country levels. Before this can be established, a number of other questions need to be looked at:

- what is the overall demand worldwide;
- Are AAOIFI standards being set by Shariah Scholars to ensure consistency in the principles of Shariah are being met;
- what are the risks associated with Islamic Finance.

There is no doubt that Islamic Finance is perceived to be at the beginning of its life cycle. There is scope for improvement in both range and sophistication, but at the same time there is a big need for regulation for future development.

Most importantly, the awareness, understanding and availability of Islamic finance needs to be improved within the Muslim communities themselves. There remains a danger if the Muslims do not take up these products, then those stand alone institutions like Islamic Bank of Britain and Salaam Insurance could end up facing a bleak future in years to come – and those relying on the likes of HSBC and Lloyds TSB could see their Islamic product ranges be withdrawn due to very low take-up.

Abid Shakeel
17 July 2009