
Chapter 1. Overview of Contemporary Islamic Finance

The basic principles underlying Islamic financial transactions are that the purpose of financing should not involve an activity prohibited by *Shari'a* (Islamic law) and that the financing must not involve *riba* (the giving or receiving of interest) and should avoid *gharar* (uncertainty, risk, and speculation). For instance, because gambling is against *Shari'a*, any arrangement to finance a casino would always be against *Shari'a*. *Riba* and *gharar* will be explained at length later. At this point, the main aspect is that *riba* includes interest charged on lending money whereas *gharar* includes excessive uncertainty regarding essential elements of a contract, such as price in a contract of sale.

Islamic finance promotes the sharing of risk and reward between contracting parties. The degree of sharing varies by contract. An example of financing that involves a relatively high degree of risk-and-reward sharing is venture capital; a contract that has a relatively low degree of risk-and-reward sharing is sale of an asset on installment credit. The financier assumes either the risk of the outcome of the business or the risk of ownership of an asset before it is sold. Neither risk is assumed in money lending, where the main risk assumed by the financier is credit risk—that is, the risk that the one being financed will lack the ability or the willingness to pay the money owed. Credit risk is also present in installment credit sales, but it is in addition to, not in substitution of, ownership risk.

Contemporary Islamic finance incorporates these principles and the other doctrines of the Muslim faith in a wide variety of products to meet the growing global demand for *Shari'a*-compliant investment and financing. The spread of Islamic financial principles is supported by the fact that Islam permits the accumulation of wealth as long as the source of wealth generation does not breach Islamic principles (that is, the activities are *halal*, or permissible),¹ *zakat* (a religious tithe) is paid, and wastefulness is avoided.

Origins of Islamic Banking and Finance

Collins (1881) described the origin of banking as “beyond the range of authentic history” (p. 11). According to Collins, banking may be assumed to have emerged as a necessary outgrowth of commerce. The notion of a medium of exchange was born because of the inconvenience of meeting and matching in barter trade, which commenced as civilizations evolved, and because people’s needs increased and

¹The statement on the permissibility of the accumulation of wealth can be found in “Islamic Capital Market Review” (2005).

self-sufficiency declined. Because the mighty institution of banking arose after the establishment of an appropriate medium of exchange, the next logical and sequential step in the process was the development of the activities of lending and borrowing.

The first banks are believed to have originated within the temples of the ancient religions of the cultures encircling the Mediterranean Sea. In these temples, the priests and moneylenders conducted transactions and accepted deposits in what is believed to be the first currency, grain. Eventually, easier-to-carry precious metals replaced bulky grains as a means of exchange. In ancient Mesopotamia, in the area now known as Iran, evidence indicates that temples acted as the guardian places of official weights for measuring silver, the commonly used monetary medium in the region, and that records of payments, loans, and other transactions were kept in the temples.

The first stable international currency, the gold *bezant*, emerged in the fourth century and was coined by the Byzantine Empire, which bridged the medieval European and Islamic cultures through its capital in Constantinople, now called Istanbul (Grierson 1999). The availability of a widely recognized and cross-cultural currency enabled people to undertake more ambitious commercial ventures and wider travel than in the past and provided increased opportunities for private individuals to acquire wealth throughout Europe and the Middle East.

Following the emergence of stable coinage, banking activities quickly developed to accommodate international trade. Early merchant banks began to deal in bills of exchange and credit-based transactions. These new financing instruments eliminated the need for merchants to actually deliver the precious metals and coins to pay for transactions in distant ports.

In the 11th century, Western Europe, to finance the Crusades, revitalized its credit-based banking system. Thus, the combined forces of Middle Eastern and Western European banking practices were exported around the world as the nations of these regions undertook new global exploration and international trading relationships.

Nevertheless, Goitein (1971) asserted that partnership and profit-sharing financing structures—concepts that are integral to Islamic finance—continued to flourish in areas of the Mediterranean region as late as the 12th and 13th centuries. And they exist today around the world in the form of cooperatives (such as customer-owned retail or food stores), mutual *takaful* (Islamic insurance) companies, and others.

Emergence of Contemporary Islamic Finance

According to Iqbal and Molyneux (2005), partnerships and profit-sharing ventures consistent with the beliefs of Islam were commonly used to finance productive activities even prior to the teachings of the Prophet Muhammad. Over time, however, as the center of economic gravity moved to the Western world, the profit-sharing approach to structuring financial transactions fell out of favor and Western financial institutions came to dominate the capital markets. Islamic financial

institutions gradually succumbed to the ways of the West and adopted interest-based financial transactions (Iqbal and Molyneux 2005). Infighting within the Muslim community contributed to the general acceptance of Western, or conventional, financing methods.²

The establishment of the Mit Ghamr Islamic Bank in Egypt in 1963 is often viewed as the starting point of the modern Islamic banking movement. Evidence exists, however, that interest-free commercial financial transactions existed in various parts of the Muslim world several decades earlier. For instance, the institution Anjuman Mowodul Ikhwan of Hyderabad, India, made interest-free loans to Muslims as early as the 1890s. Another institution in Hyderabad, the Anjuman Imdad-e-Bahmi Qardh Bila Sud, was established in 1923 by employees of the Department of Land Development and, within 20 years, had assets worth US\$2,240 and was distributing loans of US\$100 to US\$135 per month. The bank had a membership of 1,000, which included Muslims and non-Muslims. By 1944, it had reserves of US\$67,000. These organizations made small loans to small businesses on a profit-sharing basis. Their activities continue to this day.

In the early 1960s, the convergence of political and socioeconomic factors ignited interest in the revival of faith-based Islamic financial practices, including the prohibition of usury, or the giving or receiving of interest (*riba*). Although “usury” is commonly used today to mean an excessive rate of interest, it applies in this context to any charging of interest for the use of money. Islamic finance makes a distinction between usury and a “rate of return or profit from capital.” Profit in a business venture is determined *ex post*—that is, *depending on the outcome of the venture*—in contrast to interest, which is determined *ex ante*—that is, *regardless of the outcome of the venture*. Profit in a trade or a sale may be determined *ex ante*, but it is based on trading real assets between contracting parties, not the lending of money on interest (Iqbal and Tsubota 2006).

Iqbal and Tsubota (2006) asserted that, although the prohibition of *riba* is the core of the Islamic financial system, the system’s prevailing practices also reflect other principles and doctrines of Islam, such as the admonition to share profits, the promotion of entrepreneurship, the discouragement of speculative behavior, the preservation of property rights, transparency, and the sanctity of contractual obligations. The Islamic financial system “can be fully appreciated only in the context of Islam’s teachings on the work ethic, wealth distribution, social and economic justice, and the expected responsibilities of the individual, society, the state, and all stakeholders” (p. 6).

²A different version of this history is told in some academic literature (notably Kuran 2004). This literature asserts that the basic principles of what is now known as Islamic finance were not followed in what Westerners call medieval times. Instead, Kuran says, what are now known as Islamic financial principles were first set forth by, among others, the Pakistani scholar Abul Ala Maududi (1903–1979). This monograph presumes that Islamic financial principles have an ancient origin.

Nevertheless, not all Muslims embrace Islamic finance with open arms. Efforts within the Islamic finance movements are being made to use *hey'al* (ruses or deceptive practices) to circumvent *Shari'a*, as was done in other Abrahamic faiths; that is, from the Muslim perspective, followers of the Judeo-Christian religions have rejected similar admonitions to forswear usury.

Mahmoud Amin El-Gamal, who holds the Islamic finance chair at Rice University in Houston, Texas, claims that the Islamic finance industry is selling overpriced products to the religiously and financially naive and that some of the product differentiation between Islamic and conventional financial products appears to be hairsplitting. El-Gamal has said:

Both the sophisticated investors and the ultra-puritans will see through this charade. So you're left with the gullible who don't really understand the structure. . . . Muslims around the world have among the worst rates of literacy. . . . Take that same money and give it to charity. (Quoted in Morais 2007)

The U.S. banker Muhammad Saleem made similar remarks critical of Islamic finance in his 2006 book *Islamic Banking: A \$300 Billion Deception*.

Moreover, some have said that certain financing methods with *predetermined* markups, or profit margins, which are described in Chapter 4 (such as *bai' bithaman ajil* financing), have become a generally accepted part of Islamic finance even though these practices involve limited risk-and-reward sharing and thus resemble fixed-interest lending in significant ways.³

Basic Tenets of Islamic Finance

In contrast to the authors of these critiques, we believe that Islamic finance governed by the principles of *Shari'a* encompasses the ethos and value system of Islam. Primary tenets of Islamic finance are the avoidance of *riba* (interest), *gharar* (uncertainty, risk, and speculation), and *haram* (religiously prohibited) activities. Therefore, Islamic finance strictly prohibits interest-based transactions, but it embraces the sharing of profit and loss or, in other words, sharing of the risk by the provider and the user of the funds invested. The ownership and trading of a physical good or service is a critical element in structuring Islamic financial products.

Islamic finance encourages active participation of financial institutions and investors in achieving the goals and objectives of an Islamic economy. It merges the ethical teachings of Islam with finance as a means to meet the needs of society and to encourage socioeconomic justice. Through *haram*, Islamic finance prohibits trading in, for example, alcoholic beverages, gambling, and pork.

³Usman Hayat in a private communication with the authors.

The primary players in the Islamic financial system are Islamic banks and the Islamic “windows” of conventional, or Western, banks. An Islamic bank has been defined in the following ways:

- The general secretariat of the Organisation of the Islamic Conference, an association of 56 Islamic states promoting solidarity in economic, social, and political affairs, defines an Islamic bank as “a financial institution whose statutes, rules, and procedures expressly state its commitment to the principle of *Shari’a* and to the banning of the receipt and payment of interest on any of its operations” (Ali and Sarkar 1995, p. 22).
- The Malaysian Islamic Banking Act 1983 states that an Islamic bank is “any company which carries on Islamic banking business and holds a valid licence” (Part 1). Islamic banking business is further defined as that “whose aims and operations do not involve any element which is not approved by the Religion of Islam” (Part 1).
- The Central Bank Law of Kuwait (1968, as amended in 2003) stipulates that Islamic banks “exercise the activities pertaining to banking business and any activities considered by the Law of Commerce or by customary practice as banking activities in compliance with the Islamic *Shari’a* principles.”⁴

Exhibit 1.1 summarizes the differences between conventional and Islamic banking.

Objectives of *Shari’a* in Islamic Finance

The objectives of *Shari’a* and the objectives of Islamic financial institutions may differ. If, however, industry practices are in line with the substance of *Shari’a*, they should lead to fulfillment of the objectives of *Shari’a*.

The principal objective of *Shari’a* as explained in literature on Islamic finance is economic justice through equitable distribution of resources. The rationale offered is quite simple. Lending money for interest directs the flow of money to those who are considered low credit risks (a government, for instance) or those who can provide collateral (say, a rich individual or a big company), even if they may not have the businesses and ideas with the greatest economic potential. Such behavior, it is argued, leads to such economic ills as the concentration of wealth in a few hands, which, in turn, have wide social implications.

The objective of Islamic financial institutions is the pursuit of profits without violating *Shari’a*. The shareholders of and investors in Islamic financial institutions

⁴The original law may be found at www.cbk.gov.kw/www/law.html; the amended law is at www.cbk.gov.kw/PDF/Stat-Law-amend.PDF.

Exhibit 1.1. Comparison of Islamic and Conventional Banking

Characteristic	Islamic Banking System	Conventional Banking System (interest based)
Business framework	Functions and operating modes are based on <i>Shari'a</i> , and Islamic banks must ensure that all business activities are in compliance with <i>Shari'a</i> requirements.	Functions and operating modes are based on secular principles, not religious laws or guidelines.
Interest charging	Financing is not interest (<i>riba</i>) oriented and should be based on risk-and-reward sharing.	Financing is interest oriented, and a fixed or variable interest rate is charged for the use of money.
Interest on deposits	Account holders do not receive interest (<i>riba</i>) but may share risk and rewards of investments made by the Islamic bank.	Depositors receive interest and a guarantee of principal repayment.
Risk sharing in equity financing	Islamic banks offer equity financing with risk sharing for a project or venture. Losses are shared on the basis of the equity participation, whereas profit is shared on the basis of a pre-agreed ratio.	Risk sharing is not generally offered but is available through venture capital firms and investment banks, which may also participate in management.
Restrictions	Islamic banks are allowed to participate only in economic activities that are <i>Shari'a</i> compliant. For example, banks cannot finance a business that involves selling pork or alcohol.	Conventional banks may finance any lawful product or service.
<i>Zakat</i> (religious tax)	One of the functions of the Islamic banks is to collect and distribute <i>zakat</i> .	Conventional banks do not collect any religious tax.
Penalty on default	Islamic banks are not allowed to charge penalties for their enrichment. They may, however, allow imposition of default or late-payment penalties on the grounds that these penalties discourage late payments or defaults, which impose administrative costs on banks for processing and collecting the amount owed. Penalties may be donated to a charity or used to offset collection costs.	Conventional banks normally charge additional money (compound interest) in case of late payments or defaults.
Avoidance of <i>gharar</i>	Transactions with elements of gambling or speculation are discouraged or forbidden.	Speculative investments are allowed.
Customer relationships	The status of an Islamic bank in relation to its clients is that of partner and investor.	The status of a conventional bank in relation to its clients is one of creditor and debtor.
<i>Shari'a</i> supervisory board	Each Islamic bank must have a supervisory board to ensure that all its business activities are in line with <i>Shari'a</i> requirements.	Conventional banks have no such requirement.
Statutory requirements	An Islamic bank must be in compliance with the statutory requirements of the central bank of the country in which it operates and also with <i>Shari'a</i> guidelines.	A conventional bank must be in compliance with the statutory requirements of the central bank of the country in which it operates and in some places, the banking laws of state or other localities.

may have purely economic considerations and not be concerned with the objectives of *Shari'a*. Among the most important policies or goals pursued by the Islamic financial system are the following:

- ***Shari'a*-compliant financial products and services.** To be *Shari'a* compliant, the financial products and services must not be based on the payment or receipt of interest. Kuran (2004) quotes the Islamic economist Afzalur Rahman as saying that interest “inculcates love for money and the desire to accumulate wealth for its own sake. It makes men selfish, miserly, narrow-minded, and stonehearted” (p. 8). This view corresponds roughly to the persona of the money lender Shylock in Shakespeare’s *The Merchant of Venice*. Indeed, literature in various cultures, including South Asia, portrays individual money lenders in a negative light. Not surprisingly, “usurer” has particularly negative connotations.
- **Stability in money value.** Stability in the value of money is believed to be enhanced by requiring that currency be backed by an underlying asset, which enables the medium of exchange to be a reliable unit of account. Islam recognizes money as a store of wealth and as a means of exchange but does not view money as a commodity that should be bought and sold at a profit (Ismail 2005).
- **Economic development.** Participatory-type financing for infrastructure projects, based on *mudharabah* (profit sharing) and *musyarakah* (joint venture), is designed so that investment returns to both the provider and the user of funds will reflect the success of the project. The mechanism of sharing profits leads to a close working relationship between bank and entrepreneur and is believed to encourage economic development as a result of the bank’s equity-type stake in the financed project (versus an interest-only or fixed profit potential).
- **Social development.** *Zakat* (a religious tithe) is paid by Muslims and deposited into a fund that is distributed to the poor directly or through religious institutions. *Zakat* is imposed at a rate roughly equivalent to 2.5 percent of the market value of an individual’s real and financial property. *Zakat* may also be imposed on the initial capital of an Islamic bank, its reserves, and its profits. *Zakat* is one of the five main pillars of Islam and is one of the most significant manifestations of social solidarity in Islam. The understanding is that social welfare and development of the poor are improved through the collection of *zakat*.
- **Resource optimization.** Funding is provided only for projects that, in the bank’s estimate, have the most favorable return-for-risk forecasts, in addition to meeting the criterion of being socially beneficial. Projects are selected primarily on the basis of their anticipated profitability rather than the creditworthiness of the borrower (Al-Omar and Abdel-Haq 1996).
- **Equitable distribution of resources.** One of the aims of Islamic banking is to serve the less fortunate by promoting the equitable distribution of resources. The distribution of income and resources of Islamic financial structures is intended to be proportionate to the value offered by participating parties.

Principles of Islamic Finance

Islamic finance is based on the themes of community banking, ethical banking, and socially responsible investing. Its goal is to be an ethical, indigenous, and equitable mode of finance. The five key principles that govern Islamic finance are as follows.

Freedom from *Riba*. *Riba* is Arabic for “growth” or “increase” and denotes the payment or receipt of interest for the use of money. The Quran, the Muslim holy book, expressly forbids *riba*, which includes any payment of interest (not only excessive interest) on monetary loans. The Quran states, “O You who believe! Fear Allah and give up what remains of your demand for usury, if you are indeed believers.” (Recall the previous comment that in its traditional definition, “usury” encompasses any payment of interest.) Muslim scholars have interpreted *riba* to mean any fixed or guaranteed interest payment on cash advances or on deposits (Mahmood 2004).

In prohibiting *riba*, Islam seeks to foster an environment based on fairness and justice. A loan with a fixed return to the lender regardless of the outcome of the borrower’s course of action is viewed as unfair. *Riba* is also believed to be exploitative and unproductive because it is considered to represent sure gain to the lender without any possibility of loss as well as a reward in return for no work. These factors are believed to lead, in turn, to inflation and unemployment and to stifle the social and infrastructural development of a nation.

Risk-and-Return Sharing. *Shari’a* prohibits Muslims from earning income by charging interest but permits income generation through the sharing of risks and rewards (*mudharabah*) between the parties to a transaction. This profit-sharing mechanism is believed to encourage people to become partners and work together rather than to enter into a creditor–debtor relationship. Partnership promotes mutual responsibility for the outcome of the financed project, which is believed to increase the likelihood of success of the venture. A tangential aim of the partnership approach is that such increases in successful projects also provide stimulus to the economy.

***Shari’a*-Approved Activities.** Islamic banks may engage in or finance only activities that do not violate the rules of *Shari’a* and are permitted by Islam. To ensure that all products and services offered are *Shari’a* compliant, each Islamic bank has an independent *Shari’a* supervisory board.

Sanctity of Contract. Islam views contractual obligations and the related full disclosure of information as a sacred duty. Full disclosure is intended to reduce financial speculation (*gharar*), which is strictly prohibited by Islam, by providing as much information as possible for investors to make accurate assessments about the risks and rewards of an investment. The conditions that are necessary for a contract to be valid include a competent understanding of the underlying asset(s) and the profit-sharing ratio, as well as the presence of a willing buyer and seller. Contracts must also not offend Islamic religious and moral principles; if they do, they will be deemed illegal and unenforceable.

Avoidance of *Gharar*. *Shari'a* prohibits financial transactions that involve *gharar*, which is often translated as “deception,” “excessive risk,” or “excessive uncertainty.” Examples of *gharar* are the sale of fish in the sea, of birds in the sky, and of unripe fruits on the tree, which cause excessive and avoidable uncertainty.

Unlike *riba*, which involves the question of the presence or absence of interest, *gharar* raises the question of degree. And it does not apply to noncommutative contracts (i.e., those, such as gifts, that do not involve an exchange). It is not as well defined as *riba*, and a ruling of permissibility based on *gharar* could take into account a cost–benefit analysis. For instance, *gharar* is present in contracts where the object of the sale is not in the possession of the seller or does not exist at the time the parties enter into the contract but such contracts are permissible.

To minimize *gharar*, contracts must carefully state the terms of the agreement, particularly by giving a thorough description of the asset that is the subject of the contract and the asset’s transaction price. In a sale, if the asset being sold and its price are not clearly defined or specified, the sale contract would be considered to have excessive *gharar*.⁵

Forces Strengthening Islamic Finance

A number of forces have combined recently to cause Islamic finance to grow sharply.

Transnational bodies have been established to overcome the challenges faced by Islamic finance. For example, the Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions have been established to standardize, respectively, practices and accounting policies for Islamic financial institutions. They have succeeded in eliminating or at least minimizing many of the obstacles facing the Islamic financial system, thereby enhancing its growth.

The skill level of Islamic bankers and other Islamic capital market participants has steadily improved through greater intrabank (Islamic) and interbank (conventional) competition. Market competition has also spurred the creation of new product structures to satisfy client demands. Such progress is an essential factor in the continued development and sustainability of the Islamic financial system.

The general deregulation of the global banking sector has also assisted Islamic banking by making room for the implementation of new ideas and allowing flexibility within the system. Hence, establishing new Islamic banks (or, at least, Islamic windows in conventional banks) has been relatively easy in, for example, Southeast Asia.

Globalization has also played an important part in the growth of the Islamic financial system. Globalization has resulted in increased opportunities for Muslim countries to assist and cooperate with one another in the development of an Islamic banking system and capital market. An excellent example is the growth in the *sukuk*

⁵See also El-Gamal (2006), pp. 58–59.

(Islamic bonds) market. Currently, much discussion surrounds the possibility of establishing an international Islamic interbank market to cater to the liquidity needs of Islamic banks.

Finally, information technology (IT), as well as facilitating banking operations, has greatly helped in disseminating information to clients, capital markets, and investors. As in conventional banking and finance, the use of IT has greatly reduced the cost of operations for Islamic financial institutions and improved the convenience of banking operations for bankers and customers. Thanks to IT, data and information on Islamic finance can now be obtained in real time from various sources for free or at a low cost. This development has allowed more and more people to understand and use Islamic finance.

Exhibit 1.2 summarizes these drivers and lists other drivers of growth in Islamic finance in recent years.

Exhibit 1.2. Drivers of Growth in Islamic Finance

Economic growth and liquidity	<ul style="list-style-type: none"> • Strengthened oil prices • Solid economic growth in the Gulf Cooperation Council (GCC) • Increased wealth being retained in the region as investment opportunities improve • Increased government spending and investment in infrastructure/development projects
Investor appetite for <i>Shari'a</i> -compliant instruments	<ul style="list-style-type: none"> • <i>Shari'a</i>-compliant instruments becoming increasingly popular with investors • Testified to by rapid emergence of <i>sukuk</i> (Islamic bonds) • Increase in desire of family enterprises to tap liquidity in order to go public
Privatization and foreign direct investment (FDI)	<ul style="list-style-type: none"> • Increased GCC privatization initiatives accelerating project finance and structured finance activity • Strong and improving FDI potential in the region because of rising sovereign ratings and human development
Regulatory changes	<ul style="list-style-type: none"> • Improving regulatory infrastructure • Liberalization of country markets and increased investor friendliness • Increased foreign participation
Diversification	<ul style="list-style-type: none"> • Movement of GCC countries' investments into nonoil sectors • Investor funds diversifying regionally throughout the GCC and greater Middle East region
Globalization	<ul style="list-style-type: none"> • Islamic financial instruments increasingly accepted globally because of globalization • Foreign regulators (e.g., in United States, United Kingdom, European Union, Canada, and Singapore) accepting Islamic finance • Entry of global players in Islamic finance

Note: The GCC consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

Source: Dauphine (2007).