

CIFE01: WHY ISLAMIC FINANCE?

What makes Islamic finance different from conventional finance? And what makes it better? We look at 3 real-world examples and find out. We also introduce you to the 4 principles that guide Islamic finance transactions.

The difference between Islamic finance and conventional finance is the difference between buying and selling something real and borrowing and lending something fleeting.

Conventional banking transactions are interest based.

Islamic bank transactions are asset or service backed.

An asset or service cannot be compounded like an interest based loan. An asset or service can only have one buyer or seller at any given time, whereas interest allows cash to circulate and grow into enormous sums.

Interest creates an artificial money supply that isn't backed by real assets resulting in increased inflation, heightened volatility, rich getting richer, and poor getting poorer.

Nigerian President Obasanjo – Example

Nigeria took a \$5 billion loan in 1985 and paid it off as \$44 billion in 2000 as a result of compound interest.

How would the Islamic bank manage such a developing country's need?

- An Islamic bank could have arranged for the \$4 billion construction of a natural gas pipeline and delivered it to Nigeria for \$5 billion using an Istisna.
- Or taken an equity stake in a highway project and shared in profits and losses using Musharakah or Mudarabah.
- Or purchased commodities and sold them at a premium using a Murabaha.
- Or structured a project financing using an Ijarah Sukuk.



Nick the Homebuyer – Example

In 2009 Nick lost his job, his house, and all the money he had spent paying off his mortgage.

The property bubble that triggered the global financial meltdown could not have happened if the properties had been financed Islamically because a conventional bank merely lends out cash. Legally, it can keep lending this cash over and over, well above its actual cash reserves.

An Islamic bank, on the other hand, has to take direct ownership of an actual asset. Whether for a longer period in a lease or partnership, or a shorter period in a sale or trade, Islamic finance always limits the institution to an actual asset.

How could Islamic finance have fulfilled Nick's need for a home?

Based on a *Diminishing Musharakah*.

Musharakah refers to partnership. In a Diminishing Musharakah, the bank's equity keeps decreasing throughout the tenure of the financing, while the client's ownership keeps increasing through a series of equity purchases. Eventually, the client becomes the sole owner.

At no time does the homebuyer pay any interest and at no time does any payment compound. The homebuyer just pays for two things: the house, in small payments, little by little. And the rent, for the portion of the house he doesn't yet own.

Faisal the Student – Example

Faisal took a student loan. His university cost him \$120,000 for four years. He began borrowing \$30,000 at the beginning of each year. Three years after graduation he began paying off his student loans at the rate of \$20,000 a year.

It took him 25 years to pay off his loan and he ended up paying over \$400,000.

How would an Islamic bank fulfill Faisal's need?

An Islamic bank could structure a service-based *Ijarah* to lease out the university's credit hours. Faisal ends up paying about 20% or 30% more; but with the interest-based loan, he pays about 400% more.

Islamic finance never can, and never will be able to grow Faisal's debt once it's fixed.

Islamic Finance Essentials

All banking products can largely be divided into the following 4 categories:

1. Equity
2. Trading
3. Leasing
4. Debt

Some important Islamic finance transactions:

- Equity based - Mudarabah, Musharakah, and Sukuk
- Trade based - Murabaha, Salam, and Istisna
- Lease based - Ijarahs

Islamic banking transactions must:

1. Be interest free.
2. Have risk sharing and asset and service backing: Based on the Islamic concept of “no return without risk.” An Islamic bank takes a direct equity position, or buys a particular asset and charges a premium through a trade or a lease. It uses risk mitigants, but not without first taking ownership risk.
3. Have contractual certainty: Contracts play a central role in Islam and the uncertainty of whether a contractual condition will be fulfilled or not is unacceptable in the Shariah.
4. Be ethical: There is no buying, selling, or trading in anything that is, in and of itself, impermissible according to the Shariah for instance dealing in conventional banking and insurance, alcohol, and tobacco.