

## **PART ONE**

# **Background to Islamic Finance**

## 1.1

# Religious Foundations of Islamic Finance

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## Introduction

Islamic finance and banking products and instruments set out to achieve the same business goals as conventional financial products and instruments, but within the constraints of Islamic rulings. The Islamic rulings have been laid down from various sources which we examine below. Their intent is to create a just and socially inclusive system across the broad spectrum of society – and this clearly includes the financial and business elements therein. While neither money nor wealth is, *per se*, disapproved of, Islam teaches that money must be used in a productive manner and the rewards of wealth should be derived from profit-and-loss sharing arrangements that imply risk-sharing.

These Islamic rulings are codified in Islamic law, or Shari'a. The literal meaning of Shari'a is "way" or "path to the water source"; technically, it refers to the laws contained in or derived from The Qur'an and Sunnah of the Prophet Muhammad and embodies all aspects of Islamic faith including beliefs and practices. In order to understand how Shari'a law operates it is necessary to have basic knowledge of the structure of Islam, and some of the main concepts and terms involved.

## Primary sources of Shari'a

Shari'a, though understood narrowly by some as Islamic law, is in reality a complete and comprehensive code of behaviour, governing the moral, ethical, spiritual, social as well as legal dimensions of a Muslim's private and public dealings.

Shari'a rulings are taken from the Quran – the main Islamic text – and agreed by all Muslims as being both the original words of Allah (God) as revealed to the Prophet Mohammed and infallible. Shari'a is also based upon the *Sunnah*, the traditions and practices of the Prophet Mohammed. *Hadith* is the record of the *Sunnah*. The name of the main Islamic denomination, *Sunni*, is derived from the word *Sunnah*, which comprises nearly 85 per cent of Muslims worldwide and has four schools of thought:

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1. Hanifi;
2. Maliki;
3. Sha'afi; and
4. Hanbali.

The other denomination is *Shia*, which follows the *Jafiri* School of thought. However, all Muslims irrespective of whether they are *Sunni* or *Shia*, agree on the Quran and *Sunnah* and therefore, these are considered as the primary sources for Shari'a.

## Secondary sources of Shari'a

Where the analysis of legal issues is not covered precisely in the Quran and the *Hadith*, the following secondary sources are the basis of particular rulings:

- *Ijma* (consensus of scholars on a particular issue);
- *Qiyas* (analogical deduction from rulings already derived from the Quran, *Sunnah* and *ijma*);
- *Ijtihad* (rational independent deduction by qualified Islamic scholars); and
- *Urf* (common practice and custom).

The different denominations may not agree on the applicability of all these sources, and the different schools within these denominations may interpret an issue differently based upon these sources, and it is from these differences that disparities in opinion occur when considering Islamic financial products.

Generally, *Sunnis* give greater importance to *ijma* than the *Shias* do. Mohammed Hasim Kamali, professor of law at the International Islamic University of Malaysia, states in his book "Principles of Islamic Jurisprudence":

It must be noted ... that unlike the *Quran* and *Sunnah*, *ijma* does not directly partake of divine revelation. As a doctrine and proof of Shari'a, *ijma* is basically a rational proof. The theory of *ijma* is also clear on the point that it is a binding proof.

*Qiyas* is the next source of Shari'a and is widely accepted by *Sunni* Muslims, but not accepted by *Shia*. *Qiyas* is where an existing ruling is extrapolated to a connected (but not explicitly mentioned) action. The *Shia* rather look to *aql*, or intellectual reasoning, in place of analogy (see next paragraph on *ijtihad*). While the results of *qiyas* and *aql* maybe similar, it is the jurisprudential explanation and its process that causes the debate and

divergences. For a law to be upheld, especially one that derives from a source such as the Quran, it is critical that the intellectual process can be proved.

*Ijtihad* is an increasingly important source in the development of modern Islamic finance. It is an intellectual process where a judgement is made independent of case law or precedent. It allows Islam to develop in new environments. Historically, the influence of *ijtihad* lessened in the 15<sup>th</sup> century, and it has been noted that this coincides with the time when Islam ceased to be the leading innovator of modern ideas and practices and the European renaissance began. For some, the debate over *ijtihad* is more about who can perform *ijtihad* than the need for it in the first place. *Ijtihad* is only acceptable if its decisions come from an appropriately enlightened and trained scholar – a *mujtahid*.

The development of new financial products clearly creates situations where there are no direct references from primary sources – complex financial products being inventions of the modern era and not conceivable in the 15<sup>th</sup> century. Therefore, the acceptability of *ijma*, *qiyas* and *ijtihad* is of great importance to Shari'a board members in deciding whether new financial products can be Shari'a-compliant or not.

## Fiqh al-muamalat

*Fiqh al-muamalat* are laws regarding relationships between human beings which include economic transactions. Many of these were established centuries ago. During Islam's "golden age" – approximately the period from the time of the Prophet Mohammed until the fall of Al-Andalus in 1492 – the Islamic world developed the most sophisticated system of trade and currencies the world had yet seen. The processes created during this period provide a broad basis from which to construct and extrapolate rules that can be applied to modern day financial transactions.

## Core principles

Shari'a as applied to finance is based around two core concepts. The first is that the charging of interest, commonly denoted as *riba*, is forbidden. This is to avoid exploitation; apart from a lender profiting at the expense of a borrower by charging high interest rates, if a lender gets a fixed return (eg. 6 per cent), and a borrower makes very high profit (eg. 30 per cent), then it is unfair to the lender and vice versa. The second major element is that activities that are not *halal* (permissible) in Islam are therefore not permissible to be involved in economic transactions, whether that be the granting of loans for *haram* (unlawful) activities or investing in companies that conduct unlawful activities. The general principle of permissibility of economic activities in Shari'a is that every economic activity is permissible unless explicitly prohibited.

The implications of not being able to charge interest are far-reaching, as interest in one form or another plays a role in most conventional financial products. The finer interpretation of the lender not profiting from the borrower, however, does give more room for manoeuvre, and we shall see that certain products interpret this in different ways.

The screening of investments and loans to ensure that they are not for businesses or projects that operate in Shari'a unlawful activities is also a complex and, to an extent, subjective process. Activities that are *haram*, or unlawful under Shari'a, but are legal under western norms are generally those activities which are also socially unacceptable to some degree or another in the West. The most obvious of these commercial activities would be pornography, alcohol and armaments. In addition to these are the food-related *haram* activities, such as the rearing and manufacture of pork-based products. Finally, there are also activities which are *haram* because they involve *gharar*, which refers to excessive uncertainty of outcome or subject matter or date of delivery of goods/asset under contract. Another prohibition is *qimar* (or *maysir*), which refers to gambling or games of chance, and clearly many forms of speculative business activity can come under this heading as well.

Ultimately, whether Shari'a-compliant financial products are created or not comes down to the decisions of the financial institutions' Shari'a boards who examine the products and decide whether they are legitimate or not from the Shari'a perspective. Their opinions may differ due to nuances of interpretation of various sources and school of thought they follow.

## Liberals and conservatives

Approaches to Islamic development have often been categorized as either being liberal (ie. "if it is not specifically prohibited then it is permissible") and conservative (ie. "if it is not specifically permitted then it is prohibited"). This stark division does not really work with respect to developments within Islamic finance, as Shari'a board members are almost always making judgements on new issues with the assumption that economic activity is permitted unless prohibited, so they are to that extent all liberal in their approach. However, there is undoubtedly a difference in approach between some boards and others. Some require strict adherence to basic Shari'a principles, such as those in Saudi Arabia, and may be termed as having an approach based on "prudence". While others are more "market-oriented" in approach, particularly in Malaysia, and may give exemptions to normal principles considering the situation as a "law of necessity".

An example of this would be the development of *bai al-inah* contract, which has been developed and used in Malaysia as a loan product, but has not been approved in the Gulf Cooperation Council (GCC) region. Malaysian Shari'a scholars see *bai al-inah* as permissible, as it comprises "two independent sales between sane persons", and any mutually agreed sale of

a *halal* good/asset between two sane persons is acceptable to Shari'a. However, scholars in the GCC region (and other markets) look at the structure in totality, and as it resembles a conventional loan structure, they object to its permissibility and favour *tawarruq*, which involves at least three parties. Malaysian Shari'a scholars see *bai al-inah* as a necessary step in developing a full spectrum of products that can replicate conventional financial products; but they are seeing it as only a "stepping stone" product that will be superseded in time by a more Shari'a-compliant products as the market increases in sophistication.

These differing approaches clearly cause divergence of opinions and are now being focused on ever more closely as the Islamic financial authorities seek to establish greater standardization and harmonization of products globally.

## Modern era Islamic finance

It is generally agreed that modern Islamic finance is a creation of the modern era; the clear prohibition of *riba* meant that western banks were never established on this basis and nor were there benefits of providing a pooling of reserves and flow of liquidity to fund economic ventures. As such, the modern era of Islamic finance – though practices of profit and loss sharing such as *mudaraba* and *musharaka* predates the advent of Islam – started to evolve from around the beginning of the 20<sup>th</sup> century in Egypt, when the first western bank to open in a Muslim country (Barclays) set up a branch in Cairo.

The arrival of western banking prompted Islamic scholars to appraise its use of interest and seek ways to avoid it. By the 1950s, alternative models were being presented to conventional banking through partnership and *mudaraba* financing.

By the 1960s, the first Islamic finance-based institutions were appearing; for example, in Egypt, the Mit Ghamr Savings Association was established. Importantly, Mit Ghamr was modelled on western banking institutions (German regional savings banks) and was not a bottom-up creation for Islamic finance. The bank was successful and appealed to devout Egyptian farmers, but it was closed in 1968 by the Egyptian government which was unsympathetic to private enterprise. At the same time in Malaysia, which was dominated by western banks, Tabung Haji was established – another savings organization, this one with the purpose of enabling Muslim pilgrims to save gradually towards their annual Hajj pilgrimage in Saudi Arabia through Shari'a-compliant saving. Tabung Haji has undergone various transformations since then, but it remains the oldest Islamic finance institution in the world.

The 1970s saw the emergence of a number of Gulf-based Islamic banks, notably Dubai Islamic Bank and the Islamic Development Bank. The first

Islamic insurance (*takaful*) company was established in 1979 – the Islamic Insurance Company of Sudan.

The 1980s saw national economic systems declaring their intent to go to full Shari'a systems, backed by the 1981 Organization of the Islamic Conference in Khartoum. The International Monetary Fund started to publish information on Islamic financial structures and across the Muslim world, scholarly interest increased and a wide spectrum of products developed.

With the establishment of the Accounting and Auditing Organisation for Islamic Financial Institutions in 1990, and the Islamic Financial Services Board in 2002 setting out new standards for Islamic finance and development of financial services, the institutional infrastructure started to become much more sophisticated and western banks and institutions started to involve themselves through offering non-interest bearing bonds and indices designed for the Shari'a market.

A century after Barclays opened its Cairo branch, the Islamic finance sector was just starting to broaden its appeal to the mass retail market. It has developed at a substantial rate in the last quarter of the 20<sup>th</sup> century, each decade seeing more and more sophistication and broadening of its market. In the early years of the 21<sup>st</sup> century, it is poised to expand exponentially into the retail banking sector and become the fastest growing element of global banking. As it grows, the examination of financial products and business processes by senior Muslim scholars continues to become more sophisticated and profound. Debate and controversy will continue as certain new products emerge, which some may consider to go against the spirit of Shari'a, although their constituent elements themselves are permissible. Only through this continual invention, appraisal and reappraisal will a strong, flexible yet compliant Islamic finance structure fully develop, and expand across the world's markets.

## 1.2

# The Development of Islamic Finance in the UK

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## Introduction

Most of the growth of Islamic finance in the UK has taken place over the last five years. But the existence of Shari'a-compliant transactions in London's financial markets dates back to the 1980s. Commodity *murabaha*<sup>1</sup> type transactions through the London Metal Exchange were used, in significant volumes, to give liquidity to Middle Eastern institutions and other investors that fostered the development of a wholesale market in the UK. This did not, however, cater for retail Muslim consumers, as the products developed at the time were aimed exclusively at wholesale and high-net-worth investors. These products were relatively uncomplicated in structure and fell outside the scope of the regulators.

Retail Islamic products first appeared in the UK in the 1990s, but only on a very limited scale. A few banks from the Middle East and South East Asia began to offer simple products, such as home finance. However, these compared unfavourably with their conventional equivalents in several respects, including their generally uncompetitive pricing. Most of these products did not fall within the regulatory framework, so consumers did not have the same protection as other consumers; for example, the availability of the Financial Ombudsman Service and the possibility of redress from the Financial Services Compensation Scheme. The growth of the retail market remained slow throughout the 1990s and early 2000s.

Much has changed since then; both on the wholesale and the retail side, the quality of products has improved, a wider range of products has become available, and more players have entered the market. Today, London is seen by many firms, including Islamic as well as non-Islamic, as an increasingly important global centre for Islamic finance.

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<sup>1</sup> *Murabaha* is an agreement of sale of goods at a pre-determined profit mark-up on the price. Commodity *murabaha* is a mechanism used to create a Shari'a-compliant form of short-term deposit/placement by way of transactions in commodities, usually metals.

## Reasons for growth

There are, perhaps, six main reasons for this growth:

### Global expansion of Islamic finance

The first experience of Islamic banking in modern times seems to have been in the Middle East in the 1960s. It is, therefore, a relatively young industry and nobody really knows its exact size today. But from a small base, the market size is now estimated to be worth about £250 billion globally. There are also around 300 financial institutions around the world offering Islamic products.

Not surprisingly, the growth of the industry in the Middle East and South East Asia has influenced the UK market. Initially, products created in the traditional markets were brought into the UK by some of the key industry players, but now products developed in London are being marketed in other countries, for example in the Middle East.

### Markets and skills base

London is well placed to take advantage of these trends. It has a tradition going back to the 17<sup>th</sup> century, if not before, of being willing to innovate and respond flexibly to new ideas. London has deep and liquid markets and the exchanges are among the most frequently used venues for listing and trading financial instruments globally. The London Metal Exchange has already been mentioned.

The UK financial services industry has a proven record of developing and delivering new products and a large pool of legal, accounting and financial engineering skills on which to draw. Several of these firms have now established or expanded offices in other Islamic centres. English law is already the preferred legal jurisdiction for many Islamic finance transactions.

### Islamic windows

Several major international institutions, such as Citibank, Deutsche Bank and HSBC, have had a presence in the Middle East and South East Asia for several years. As a result, they have developed considerable knowledge and experience of local markets, including Islamic ones. To accommodate the new and growing demand for Islamic products, they have established business lines known as “Islamic windows”, some of which are based in the UK and others in the Middle East and South East Asia. These windows have contributed significantly to the development of Islamic finance because

of the institutions' global experience in product development and their access to far greater resources than those available to local institutions in the Middle East and South East Asia.

## Excess liquidity in the Middle East

The sharp rise in oil prices since 2003 has resulted in huge liquidity surpluses and a surge in demand for Islamic, as well as conventional, assets in the countries of the Gulf region. The capacity of the local financial markets has not, however, been able to develop at the same speed. As a result, demand for assets has considerably outpaced supply, and Middle Eastern investors have been looking, in large numbers, for suitable alternatives. This demand was quickly identified by Islamic and conventional institutions that now provide a channel through which assets within other markets are sold to these investors, often by way of Shari'a-compliant transactions. This has been particularly notable in the UK. A recent example is the acquisition of Aston Martin by two Kuwaiti financial institutions, using Shari'a-compliant financing.

## Public policy and taxation

Since the early 2000s, the government, for reasons of wider public policy, has introduced a series of tax and legislative changes specifically designed to remove obstacles to the development of Islamic finance. The first significant change came in the Finance Act, 2003 which introduced relief to prevent multiple payment of stamp duty land tax on Islamic mortgages. The Finance Acts 2005 and 2006 contained further measures aimed at putting other Islamic products on the same tax footing as their conventional counterparts. Most recently, the Finance Act, 2007 clarified the tax framework further, in the case of *sukuk*. This is very much work in progress.

## Single financial regulator

Another contributory factor is institutional. The establishment of the Financial Services Authority (FSA) in 1997, combined 11 different regulators into a single body under a single piece of legislation. This has done much to resolve several of complications and conflicting views stemming from the previous regulatory regime where functions were divided. In particular, the FSA is able to look across the system as a whole to assess Islamic financial institutions and products.

*This chapter appeared as part of the FSA document "Islamic Finance in the UK: Regulations and Challenges" ([http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)) published in November, 2007.*



## 1.3

# Islamic Alternatives to Conventional Finance

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## Introduction

Islamic finance has been growing at a rapid pace over the last few years. This has been accompanied with an extension of product ranges that caters to the diverse needs of investors on both the liabilities and assets side of Islamic banks. Financial solutions range from profit-and-loss sharing mechanisms, consumer finance (including for durables, credit/debit cards and housing finance), trade finance, working capital finance and project finance. Moreover, this list is evolving quickly and is providing a large number of viable alternative Shari'a-compliant solutions to conventional finance.

The emergence of Islamic financial products, particularly in capital markets, has also promoted greater global financial integration. The bringing together of financial institutions and market players across continents to participate in this expansion of inter-regional investment flows has fostered financial links amongst the major regions. This will not only provide greater synergies and opportunities, but will also contribute towards facilitating international financial stability.

## Islamic finance instruments

The main principles of Islamic finance include the following:

- Strict prohibition on paying or receiving interest;
- Risks in any transaction must be shared between the parties, so that the provider of capital and the entrepreneur share the business risk in return for a share in the profits;
- Speculative behaviour is prohibited. This means that extreme or excessive uncertainty (*gharar*) or risk is prohibited, and thus contractual obligations and disclosure of information are necessary;
- Money is seen as potential capital and can only take the form of actual

capital when it is used in a productive capacity, or combined with labour;  
and

- Every economic activity is permissible unless explicitly prohibited by Shari'a, which includes injunctions contained in, or derived from, the Quran and the *Sunnah* (sayings and practices of the Prophet Mohammed).

The main Islamic modes of financing are briefly discussed below.

## Financing through participatory modes

### ***Musharaka***

The literal meaning of *musharaka* is “sharing”. In Islamic jurisprudence, *musharaka* means a joint enterprise formed for conducting some business in which all partners share profits according to a specific ratio, while the loss is shared according to the ratio of their contribution. It is an ideal alternative for interest-based financing with far reaching effects on both production and distribution.

The key features of *musharaka* are as follows:

- The ratio of profit distribution may differ from the ratio of investment in the total capital, but the loss must be divided exactly in accordance with the ratio of capital invested by each of the partners;
- Capital that is invested by the partners can be unequal and should preferably be in the nature of currency. If it is in the shape of commodities, the market value would be determined with mutual consent to determine the share of each partner. It may also be in the form of equal units representing currency called “shares”, and the intended partners may buy these shares disproportionately;
- It is not allowed to fix a return or lump sum amount for any of the partners, or any rate of profit tied up with any partner's investment; and
- The liability of the partners in *musharakah* is normally unlimited. Therefore, if the liabilities of the business exceed its assets and the business goes into liquidation, all the exceeding liabilities shall be borne *pro rata* by all the partners. However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the excess liabilities shall be borne by that partner alone who has incurred a debt.

### ***Mudaraba***

*Mudaraba* is a kind of partnership where one partner gives money to another for investment in a commercial enterprise. The investment comes from the partner that is called *rabb al-maal*, while the management and

work fall under the exclusive responsibility of the other called *mudarib*. The profits generated are shared in a predetermined ratio.

The key features of *mudaraba* are as follows:

- One party provides the necessary capital and the other provides the human capital that is needed for the economic activity to be undertaken;
- The amount of investment shall be precisely determined and free from all liabilities;
- The entrepreneur who runs the business can be a natural person, a group of persons or a legal entity/corporate body;
- The profit earned is to be divided in a strict proportion agreed at the time of contract. The financier/investor cannot have a predetermined return or a lump sum absolute amount out of the profit;
- The operational loss is to be suffered by the *rabb al-maal* only. For the *mudarib*, the loss is in terms of unrewarded labour or entrepreneurship;
- The liability of the *rabb al-maal* is limited to his/her investment, unless the *rabb al-maal* has permitted the *mudarib* to incur any additional debt; and
- Both the parties may agree that no party shall terminate the contract during a specified period, except in specified circumstances.

*Mudaraba* is used mainly by depositors who tender their money (as capital owners) to a bank to be invested by the bank, as *mudarib*, on the basis of profit sharing according to agreed ratios. For investment funds, *mudaraba* is a high-risk venture because Islamic banking institutions provide capital to the *mudarib* who undertakes the work and management, and in case of loss, the whole financial loss will have to be borne by the bank as *rabb al-maal*, provided the loss is not caused by the negligence of the *mudarib*. The contract of *mudaraba* is traditionally applied to commerce alone, but it provides the basis of the relationships between banks, depositors and the entrepreneurs, and according to the majority of contemporary scholars, it can be applied in all sectors of the economy such as trade, industry and agriculture.

## Financing through debt creating modes

These modes belong to the “low-risk” category and normally create debt when applied by Islamic banks. However, once the debt is created, there can be no increase over the amount of credit or debt stipulated.

### ***Murabaha***

*Murabaha* is the most widely used Islamic financial contract. It is an agreed profit-margin sale with spot or deferred payment of the sale price. *Murabaha* means the sale of goods by one party to another under an arrangement,

whereby the seller is obliged to disclose to the buyer the cost of the goods sold on either spot basis or deferred payment basis, and a profit margin is included in the sale price. It is suitable for corporate, consumer, agriculture, microfinance and other sectors where the client needs finance to purchase goods. It enables the client to procure finished goods, raw material, machinery or equipment through Islamic banks from the local market or through import. Normally, it is used for short-term financing needs, as Islamic banking institutions are able to fix a price at the outset to finance the purchase of goods for onward sale to their clients.

Some important considerations in a *murabaha* are as follows:

- The commodities, which are the subject of the sale, must be existing, owned by the bank (as seller) and in the bank's physical or constructive possession. Therefore, it is necessary that the bank must have first assumed the risks of ownership before selling the commodities to the client;
- The execution of the sale contract requires an offer and acceptance, which includes certainty of price, the place of delivery and the date on which the price, if deferred, will be paid;
- The appointment of an agent, if any, and the purchase of goods by/for and on behalf of the bank and the ultimate sale of such goods to the client shall be transactions independent of each other, and shall be separately documented. The agent should first purchase the commodity on behalf of the bank (ie. the financier) and take its possession thereof. Subsequently, the client would purchase the commodity from the bank through an offer and acceptance arrangement;
- The commodity will remain at the risk of the bank during the period of purchase of the goods by the agent and its ultimate sale to the client (buyer) and until its possession by the client;
- Once the sale transaction is concluded between the bank and the client, the agreed selling price cannot be changed;
- It can be stipulated while entering into the agreement that in case of late payment or default by the client, the client will be liable to pay a penalty calculated at an agreed percentage rate per day or per annum that will go to a charity fund constituted by the bank;
- The buyer/client may be required to furnish security in the form of a pledge, lien, mortgage or any other form of encumbrance on realizable assets. However, the mortgagee or the charge-holder shall not derive any financial benefit from such security; and
- A *murabaha* contract cannot be rolled over because once sold by the bank, the goods become the property of the client, and hence cannot be resold. *Murabaha* receivables cannot be securitized for creating a negotiable instrument to be traded in a secondary market.

## **Musawama**

*Musawama* is a general kind of sale in which the price of the commodity to be traded is stipulated between the seller and the buyer without any reference to the price paid or cost incurred by the former. Thus, it is different from *murabaha* in respect of its pricing formula. Unlike *murabaha*, the seller in *musawama* is not obliged to reveal the cost or purchase price. All other conditions relevant to *murabaha* are valid for *musawama* as well. *Musawama* can be an ideal mode where the seller is not in a position to ascertain the precise costs of commodities that are offered for sale.

## **Salam**

*Salam* is a kind of sale whereby the seller undertakes to supply specific goods to a buyer at a future date, in consideration of a price fully paid in advance. It is an exceptional mode in Islamic contractual theory for a sale transaction, whereby the existence of a subject matter and its ownership or possession by the seller is not necessary at the time of sale. Some additional considerations in *salam* are as follows:

- The buyer should pay the price, in full, to the seller at the time of effecting the sale; otherwise it will be tantamount to a sale of debt against debt, which is expressly prohibited by the Shari'a rulings (any unpaid price represents a debt to the buyer and a debt to the seller for the value of such goods not paid for in advance);
- The debt liability of the seller cannot be adjusted against the price for *salam* sale, in part or in full.
- *Salam* can be affected in only those goods that are normally available in the market and whose quality and quantity can be specified exactly;
- It is necessary that the quality of the goods intended to be purchased is fully specified, leaving no ambiguity leading to dispute among the parties involved in the transaction;
- The exact date and place of delivery must be specified in the *salam* contract. The parties may fix any date for delivery with mutual consent; and
- In order to ensure that the seller shall deliver the goods on the agreed date, the bank can also ask the seller to furnish a security, which may be in the form of a guarantee or in the form of a mortgage/hypothecation.

*Salam* sales are suitable for financing agricultural operations, where the bank can transact with farmers who are expected to have the goods for delivery after harvesting, either from their own crops or from the crops of others, which they can purchase in the latter case and deliver in case their crops fail. *Salam* sales are also used to finance commercial and industrial activities, and have the advantage of elasticity to cover the needs of people working in various sectors of the economy, such as farmers, industrialists,

contractors or traders. They can cover the financing of overheads and capital goods as well.

### ***Istisna'a***

*Istisna'a* is a contractual agreement to manufacture goods, allowing cash payment in advance and future delivery or a future payment and future delivery. *Istisna'a* can be used for financing in the manufacture or construction of houses and factories, and in building bridges, roads and highways.

The key features of *istisna'a* include the following:

- It is used in the manufacturing sector where the *al-saani* (manufacturer or the seller) would arrange to provide both the raw material and the labour;
- The goods and price must be known and specified to the extent of removing any *gharar* or excessive uncertainty;
- It is not necessary in *istisna'a* that the price is paid in advance. The price can be paid in instalments within a fixed time period;
- It is not necessary for the *al-saani* to manufacture the goods. The seller may enter into a contract with a manufacturer to provide the same goods, which is the subject matter of the first *istisna'a* contract;
- In an *istisna'a* contract, before a manufacturer starts the work, any one of the parties may cancel the contract by giving a notice to the other; however, once the manufacturer has started the work, the contract cannot be cancelled unilaterally;
- The *al-mustasni* (purchaser) has the right to obtain collateral from the *al-saani* for the amount paid and with regard to delivery of the goods with specifications and time; and
- The contract may also contain a penalty clause on account of breach of the contract.

*Istisna'a* contracts have wide fields of application for Islamic banking institutions to finance public sector needs. The *istisna'a* contract is suitable for various industries, such as the aircraft industry, locomotive and ship-building industry, construction industry and food processing industry.

### ***Diminishing musharaka***

Diminishing *musharaka* is a variant of *musharaka*, and is a form of co-ownership in which two or more parties share the ownership of a tangible asset in an agreed proportion, and one of the co-owners undertakes to buy, in periodic instalments, the proportionate share of the other co-owner until the title to such tangible asset is completely transferred to the purchasing co-owner.

It is a combination of partnership and *ijara* (leasing), where the asset under co-ownership is leased by one of the parties to another before the asset can be fully acquired. It is mainly used by Islamic banking institutions for house and car financing; however, it could also be used for financing in the purchase of industrial establishments, farms and other fixed assets.

The key features of the diminishing *musharaka* are given below:

- Diminishing *musharaka* is applied for the purchase of tangible assets;
- Proportionate shares of each co-owner must be known and defined in terms of investment;
- Expenses incidental to ownership may be borne jointly by the co-owners in the proportion of their co-ownership;
- Losses, if any, shall be borne by the co-owners in proportion of their respective investments;
- Each periodic payment shall constitute a separate transaction of sale; and
- Separate agreements/contracts shall be entered into at different times in such manner and in such sequence so that each agreement/contract is independent of the other, in order to ensure that each agreement is a separate transaction.

In diminishing *musharaka*, the bank (as financier) and a client participate either in joint ownership of a property or an asset that allows the client to secure the sole ownership of that asset over a period of time. The share of the bank is divided into a number of units and it is understood that the client will purchase such units periodically. Thus, reducing or “diminishing” the bank’s share in the ownership and increasing the client’s ownership until all of the bank’s units are purchased, so as to make the client the sole owner of the asset. This arrangement allows the financing bank to claim rent, on a reducing basis, from the client for using the asset according to the proportion of the prevailing ownership in the property, and at the same time allows periodical return of a part of bank’s investment through purchases of the units representing the bank’s share of the asset.

### ***Ijara***

*Ijara* is equivalent to conventional leasing; however, there are some key differences, such as the requirement of the lessor to assume the risk relating to ownership of the leased asset at all times, and any sale to the lessee at the end of the lease period to not be a condition of the leasing contract. The bank’s income is derived from the profit charged on the cost of a leased asset, and this profit is included with the cost in the lease repayments. Although *ijara* is strictly not a financing mode, Islamic banking institutions are extensively using it as such to acquire fixed assets for their clients because it does not involve interest payments, is easily understood and can be used in order to obtain tax concessions in certain countries. The question as to

whether or not the transaction of leasing can be used as a mode of financing in the context of Shari'a will depend on the terms and conditions of the contract.

## Conclusion

Islamic finance is quite different from conventional finance, based on Shari'a injunctions, and is strictly against exploitative transactions that involve *riba*, excessive uncertainty, speculation and debt trading. Islamic finance is based on "material finality", which implies a strong link between the financial transaction and real economic activity. This link insulates Islamic finance from overheating and creating asset price bubbles that have led to financial crises.

Islamic financial products provide a multitude of alternatives to conventional finance, and have been re-engineered in such a way that creates conformity to conventional finance with comparability of returns. Innovations, such as *sukuk* (Islamic bonds) and diminishing *musharaka*, are structured so as to combine features from two or more Islamic financial contracts. These combination structures are designed to suit the financing requirements of various clients on both the consumer and corporate sides.

Islamic banking, based on Shari'a, prohibits interest in all its forms and emphasizes trade as the major focus of all economic activities. Shari'a does not allow rent-seeking behaviour on capital, whilst the rewards are tied-up with risk taking – there should be no reward without assuming risk. The Islamic economic system strives to achieve a socially responsible economic order, the eventual goal of which is value creation through ethical business activities besides ensuring equal economic opportunities, especially for the deprived segments of the population. This requires a paradigm shift from a focus on debt-based financial intermediation to participatory modes.

## 1.4

# The Institutional Infrastructure Supporting the Islamic Finance Industry

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## Introduction

There are four major international institutions concerned with the Islamic finance industry:

1. The Fiqh Academy;
2. The Islamic Development Bank;
3. The Islamic Financial Services Board; and
4. The Accounting and Auditing Organization for Islamic Financial Institutions.

The role and significance of these institutions is reviewed here, together with other major organizations providing data and information on Islamic finance. In terms of education and training, institutions providing professional qualifications in Islamic finance include:

- The Institute of Islamic Banking and Insurance, UK;
- The International Centre for Education in Islamic Finance, Malaysia; and
- The Chartered Institute of Management Accountants, based in the UK but with worldwide offices, which launched a certificate in Islamic finance in 2007.

There are also universities offering academic qualifications in Islamic finance, such as the International Islamic Universities in Malaysia, Pakistan and Bangladesh, and the CASS Business School, UK, which has an Islamic finance stream for its executive Masters in Business Administration (MBA) offered in Dubai. The Faculty of Islamic Studies in Qatar is launching a Masters of Science (MSc) in Islamic Finance in September 2008. Postgrad-

uate research degrees, including at PhD level, are offered by Durham University.

## The Fiqh Academy

To determine whether financial products comply with Shari'a, the opinions of scholars trained in Islamic jurisprudence (*fiqh*) are sought. Their rulings, or *fatwa*, are regarded as definitive, but as Islam is not a centralized or hierarchical religion, there are many competing, and sometimes contradictory *fatwas*. It was to resolve these conflicts that the Islamic Fiqh Academy was established in Jeddah in January 1981. Its mandate was agreed by the Organization of the Islamic Conference, which now serves 57 Muslim majority countries. The Islamic Fiqh Academy is therefore widely regarded as the appropriate international institution to provide guidance on moral issues of concern to the Muslim faithful. This includes guidance on medical ethics, social issues and economic matters, including finance.

Its rulings on finance are respected by the Shari'a board members of leading Islamic banks and *takaful* (insurance) operators. Notable rulings include those on the permissibility of deposit or down payment subscriptions and foreign exchange transactions, bank deposits and investment in equities, and leasing contracts. The issue of whether credit cards are permissible has also been addressed at several meetings. As the issues considered are often complex, it is not merely a matter of ruling whether a financial product or activity is permissible, but the terms under which it is permissible.

For example, in leasing (*ijara*), an operating lease is permissible as the owner of the asset has responsibility for its maintenance, which justifies the rental payment, whereas with a pure financing lease all the obligations are devolved to the lessee, invalidating the contract. Similarly, credit cards that involve *riba* payments are forbidden, but paying a subscription for a pre-determined credit limit is permissible. Sometimes, *fatwas* have been taken forward by other bodies, as with the ruling on the permissible equity investments which resulted in the Dow Jones Islamic Indexes developing their methodology to determine what business sectors are permissible for investors who want to be Shari'a-compliant. The question of financial screening to avoid excessive exposure to *riba* was also further refined by the Dow Jones Islamic Indexes.

## The Islamic Development Bank

Founded as a development assistance agency following a conference of finance ministers in 1973, the Islamic Development Bank (IDB) started operations in 1975. The original remit was to facilitate poorer Muslim countries to pay for their oil imports after the substantial price rises of the mid-1970s, with most of this financing being provided on a *murabaha* basis.

The IDB bought oil and sold it to importing countries at a modest mark-up. By the 1980s, the IDB was involved in more diverse trade financing operations, using *ijara* as well as *murabaha*, and from the 1990s it has offered project financing through *istisna'a*. This involves the IDB making payments to contractors, sub-contractors and suppliers to a project, with the repayments plus a mark-up being made once the project is complete and yielding returns. Such financing has been used for power generation schemes, transportation and communications projects and other diverse infra-structure developments.

Saudi Arabia accounts for over one-quarter of the subscribed capital of this Jeddah-based institution, Iran being the second largest subscriber with almost 10 per cent of the capital. The Islamic Republic views the IDB as a concrete symbol of its cooperation with its Gulf neighbours in helping to promote Islamic finance worldwide.

The IDB raises additional finance from Islamic banks through its specialized funds, such as the Islamic Bank's Portfolio for Investment and Development and the Unit Investment Fund, and it has also issued *sukuk* Islamic securities to secure further capital. It invests in *waqf* religious endowments, and has programmes for poverty reduction as well as scholarships for postgraduate students from poorer Muslim countries attending recognized universities. Its affiliate, the Islamic Research and Training Organization, provides organizational back-up and sponsors numerous Islamic finance conferences. The IDB has evolved into a World Bank for Muslim countries; indeed, it co-funds with the World Bank and other development assistance agencies.

## The Islamic Financial Services Board

Islamic financial assets and liabilities have different risk characteristics to their conventional equivalents, which poses a challenge for regulators. The Islamic Financial Services Board (IFSB) was established to advise regulators on how Islamic banks and other Shari'a-compliant financial institutions should be managed, and how international regulatory requirements should be adapted for this distinctive type of banking institution and financial products. Since its inception in November 2002 in Kuala Lumpur, almost 40 regulators have become members, as well as 108 market players and institutions such as the Bank for International Settlements, the International Monetary Fund, the World Bank and the IDB.

The IFSB has already issued detailed standards, following studies identifying best practice and widespread consultations with the Islamic financial services industry and beyond. These standards cover the following:

- Capital adequacy in relation to Basel I and II requirements;
- Risk management, including credit, operational and market risk; and
- Corporate governance.

It is currently drafting new standards to cover *sukuk* securities, Shari'a compliant investment funds, *takaful* operations and Shari'a governance. The aim of the IFSB is to spread awareness of regulatory challenges within and beyond the Muslim world. The Financial Services Authority of the UK has taken an active interest in its deliberations. As the Islamic finance industry involves many cross-border transactions, the need for international standards has become more urgent, and the IFSB has played a major role in facilitating harmonization and convergence of regulatory practices.

## The Accounting and Auditing Organization for Islamic Financial Institutions

Financial reporting for Islamic financial institutions is also challenging because of the unique nature of their assets and liabilities. There is the question, for example, of whether *murabaha* assets should be valued at their cost to the bank or their cost to the client, which includes the mark-up. The relevant Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standard suggests the latter. Similarly there is the issue of whether income from *murabaha*, *ijara* and *istisna'a* assets should be booked as it accrues, or at the end of the period when the financial institution has its funding returned. Again, AAOIFI suggests the former.

AAOIFI was established in Bahrain in March 1991 to support the Islamic financial services industry, and its standards are now mandatory in Bahrain, Qatar, Jordan, Lebanon, Sudan and Syria, as well as being implemented by the Dubai International Financial Centre. The regulatory authorities in Saudi Arabia, Indonesia, Malaysia, Pakistan, Australia and South Africa have issued guidelines based on the AAOIFI standards. To date, AAOIFI has issued 22 accounting standards, five auditing standards, four governance standards and two codes of ethics. It has also issued 21 Shari'a standards that were approved by its own Shari'a board.

The aim of AAOIFI is not to replace the International Financial Reporting Standards (IFRS), but rather supplement them with respect to Shari'a-compliant assets and liabilities and the income flows associated with these. Even in jurisdictions where AAOIFI standards are not mandatory, most Islamic financial institutions implement them in practice, and refer to AAOIFI in their annual financial reports and interim reports. As with the IFSB, as leading Islamic banks expand beyond their countries of origin, a consistent set of accounting standards facilitates the consolidation of their financial statements, which is helpful for both their shareholders and the regulatory authorities.

Other stakeholder groups are also important to AAOIFI, such as the investment *mudaraba* account holders with Islamic banks who earn a profit share. They are entitled to know the basis of how the profit share is calculated, and the amount placed in the profit equalization fund from which

they may benefit in the longer term, but at the expense of a smaller profit distribution in the short term. AAOIFI sponsors an annual Islamic finance conference in Bahrain, and organizes regular training sessions for accountants where its standards are explained.

## Information sources

There are comprehensive news and data sources serving the Islamic financial services industry. Online subscription services include the Islamic Finance Information Service (IFIS) of ISI Emerging Markets, which is a Euro-money affiliate based in London, and Islamic Finance News (IFN), based in Malaysia. IFIS provides comprehensive information, including data on *sukuk* issuance, managed funds, syndications and *takaful*. The annual reports and interim statements of most Islamic banks can be accessed through it, as can legal reports, supervisory documents and research materials. The databases within the system can be searched by year, country and product. IFN provides a weekly newsletter covering the latest developments in the industry, with historical information also available online. It contains interviews with industry leaders, and a forum where topical questions are addressed by a number of professional and academic specialists.

There are three major print magazines on Islamic finance:

1. New Horizon, the publication of the Institute of Islamic Banking and Insurance (IIBI) in London;
2. Islamic Business and Finance, published by CPI Financial; and
3. Business Islamica, published by Tradewind.

Both Islamic Business and Finance and Business Islamica are located in Media City, Dubai. Islamic Business and Finance and Business Islamica are published monthly, whilst New Horizon has become a quarterly publication. All are largely funded by advertising, although Business Islamica has a nominal newsstand price. New Horizon is the longest established, as it has been published continuously since 1991 with features and regular items including a news round-up, details of IIBI lectures, appointments, a calendar of events and questions and answers. All three contain articles and interviews, with Islamic Business and Finance employing its own journalists, but much of the New Horizon and Business Islamica material outsourced. Islamic Business and Finance is organized into separate sections on capital markets, Islamic funds and *takaful*, with each edition containing an editorial and at least one interview.

## Professional qualifications

The IIBI Diploma in Islamic Finance is the oldest established professional qualification, and over 1,000 students have enrolled since the early 1990s. It is accredited by the Open and Distance Learning Quality Council in the UK, and recognized as a professional qualification. There is no need to attend classes; rather, busy professionals can work at their own pace through the materials prepared by experts. Progress is monitored through periodic question papers sent to those who enrol, with completed answers to be returned by email or post.

In 2007, the Chartered Institute of Management Accountants (CIMA) launched a new Certificate in Islamic Finance in the UK, Bahrain and Malaysia. Although an accountancy body, the modules cover most areas of Islamic finance, with assessment taking place through online, multiple-choice questions. Compulsory study modules include Islamic commercial law, banking and *takaful*, Islamic capital markets and instruments and accounting for Islamic financial institutions. Detailed study guides are provided for each module, including glossaries of Islamic finance terms, illustrations of how practice is derived from theory, and a step-by-step approach linked to specified learning outcomes. The study guides contain extensive case-study materials, chapter summaries, revision sections and full length mock examinations, consisting of 40-50 questions.

The International Centre for Education in Islamic Finance (INCEIF), based in Malaysia, offers a Chartered Islamic Financial Professional programme with both on-campus study and distance learning. The structured programme involves three parts; the first part stresses basic knowledge leading to associate membership, the second involves skills acquisition resulting in proficient membership on completion, and the third building competency and experience resulting in practising membership. The courses take between one and a half to six and a half years to complete. First stage modules include Islamic economics and finance, Islamic financial institutions and markets, Islamic finance regulations and governance, applied Shari'a in financial transactions, deposit mobilization and financial management and wealth planning. The subject skills at level two include structuring financing requirements, issuing and managing Islamic securities, Shari'a compliance and audit, customer relationship management and the role of technology and issues in Islamic financial institutions and markets. At level three, participants are articulated to participating Islamic financial institutions to gain practical experience, with validation involving problem solving, restructuring exercises, simulation and management games, product conversion and interviews.

## Academic programmes

The International Islamic University of Malaysia has undergraduate programmes in economics, accounting and business administration that enable students to get some exposure to Islamic economics and finance, although most of the course contents are conventional. At postgraduate level more specialized study in Islamic finance is possible, as is the case with the International Institute of Islamic Economics located within the International Islamic University in Pakistan, which offers a one year Postgraduate Diploma in Islamic Banking and Finance through evening study, as well as an MSc over three years with scheduled morning classes.

The UK-based CASS Business School launched an executive MBA with an Islamic finance stream in 2007. The programme is offered in Dubai in collaboration with the Dubai International Financial Centre. The two-tier programme involves established MBA modules in accounting, marketing, finance and business economics, with the Islamic finance options coming near the end of the course. The three specialist components are in Islamic economics, Islamic banking and finance and Islamic law of business transactions. In neighbouring Qatar, the Faculty of Islamic Studies, which is sponsored by the Qatar Foundation, is adding an MSc in Islamic Finance to its existing masters programmes in Islamic Studies from 2008 onwards. The new faculty is separate from the University of Qatar, but will be moving to the new Education City in Doha once its buildings are completed. Details of the new degree structure are not yet finalized.

For research degrees in Islamic finance, Durham University in the UK has become the leading international centre, attracting suitably qualified applicants from throughout the world, including Malaysia and the Gulf. A master's degree by research is offered at the university, which involves students writing a thesis of 30,000 words on an Islamic finance topic that they can negotiate with their supervisor. Doctoral degrees involving a minimum of three years of supervised study are also offered, with students writing a thesis of 80,000 words. There are dedicated research support workshops and a module on Islamic political economy and Shari'a compliant finance that students are expected to attend. PhD students spend part of their first year in Durham, but during the second and third years they often undertake fieldwork in their country of origin or elsewhere, as most of the research involves empirical studies.