Islamic Finance

Finance Basic

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1. Introduction

The present term paper is dedicated to the topic "Islamic Finance". In order to understand its importance, in the first stage today's challenges for the Islamic Financial Instruments are pointed out. In the next stage the principals of Islamic Finance are defined, and differentiated with conventional finance system as those build the basis on which this paper is written.

Islamic Financial activities is consistent s with the principles of shariah law and its practical application through the development of Islamic economics. Shariah prohibits the fixed or floating payment or acceptance of specific interest or fees (known as *riba*, or usury) for loans of money. Investing in businesses that provide goods or services considered contrary to Islamic principles is also *haraam* ("sinful and prohibited") [1]

The concept is more accurately that money has no intrinsic value – it is only a measure of value, and since money has no value itself, there should be no charge for its use. Therefore, Islamic Finance is said to be asset based as opposed to currency based whereby an investment is structured on exchange or ownership of assets, and money is simply the payment mechanism to effect the transaction. The basic framework of an Islamic Financial System is based on elements of Shariah, which governs Islamic societies. [2]

The return on savings and investment accounts are variable, and dependent on the Bank's performance and the profits from Halal business transactions only. While these profits are not necessarily guaranteed and are subject to a degree of risk, these are managed professionally to ensure better returns than many other conventional alternatives.

1.1 Islamic Finance today

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

1- Wiki Reference

2 Principals of Islamic Finance

Islamic banking has the same purpose as conventional banking: to make money for the banking institute by lending out capital. But that is not the sole purpose either. Adherence to Islamic law and ensuring fair play is also at the core of Islamic banking. Because Islam forbids simply lending out money at interest (riba), Islamic rules on transactions have been created to prevent this evil. The basic principle of Islamic banking is based on risk-sharing which is a component of trade rather than risk-transfer.

The main principles include :-

- The prohibition of taking or receiving interest as Islam vies money is not an asset that should earn a surplus on and of itself.
- Financial provider must share the risk with the entrepreneur and not only the profits.
- Capital must have a social and ethical purpose beyond pure and unfettered return Islam upholds contractual obligation Islam upholds contractual obligation and the disclosure of information as a sacred duty. This feature reduces the risk of asymmetric information and moral hazard.
- Only business activities that do not violate the rules of Islamic law qualify for investment, for example business dealing with gambling, pornography and casinos would be prohibited.

3 Instruments of Islamic Finance. [3]

It is important to appreciate that Islamic finance is more than just financial contracts. In principle, a great deal of emphasis is placed on responsible investments; client relationships; capitalism with a moral focus; and eliminating excessive uncertainty within the markets. These ideals are clearly stipulated within Islamic law. Islamic banking introduces concepts such as profit sharing (*Mudharabah*), joint venture (*Musharakah*), cost plus (*Murabahah*), and leasing (*Ijar*).

<u>3.1 Murabaha (Cost-Plus Sale)</u>

Murabaha essentially is undertaking a trade with a markup and is used for short-term financing, similar in form to purchase finance. An example would be a bank purchasing a tangible asset of some sort from a supplier with the resale based on the cost plus an agreed markup. This is most often used to finance property, since the bank would not be allowed to charge interest on any loan. Once such a debt covenant is in place between a bank and the customer, repayments can begin until a completion point where the asset is transferred to the customer. There is no exposure to variations in interest rates as there is a fixed markup percentage, identified at the outset.

<u>3.2 Mudaraba (Partnership Financing)</u>

Mudaraba is very similar to Musharaka and is a trustee type finance contract under which one party provides the labour while the other provides the capital. Mudaraba is a concept to provide capital to somebody undertaking the work. It could be understood as being similar to the function of an asset manager or employed manager of a company.

As the profits are shared with the manager and the capital provider but the losses are beared only by the capital provider this mode is also named profit sharing – loss bearing. Before the manager gets his share, the losses, however, if any, needs to be recovered. A wage could be negotiated.

3.3 Musharaka (Equity Participation)

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

It is about contributing capital to a company, project, or any kind of asset transaction. The profit and the losses needs to be shared. This method is recommended by Muslim economists as being the most fair and just method.

In a Musharaka contract all parties may take part in the management or some parties may not take part in the management (silent partnership). Losses need to be born proportionately to the capital provided by each party (pro rata). Regarding the profits there is a disagreement between the schools whether other than pro rata distribution is permissible.

3.4 Ijara (Leasing)

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

The conditions of an Ijarah contract are basically the transfer of a valuable use (usufruct) while the ownership remains with the lessor with all its liabilities involved. The period of the lease needs to be clarified in the contract and during this period the payment of rent can be negotiated freely. A forward lease is unlike in sales contracts permissible. Subleases are permissible with consent of the lessor or if similar usage could be expected.

In Islamic law it would not be possible to bind two contracts such as rent and sales in one. Each needs to be clarified precisely. Further a sales contract cannot defer the transfer of ownership and the payment for it in the future. The solution is again a promiss of the lessor, binding only to him, to sell the asset to the client at a certain price in future. Also it is possible to structure a gift in the end of the period, so that the ownership is transferred without payment.

2- World Islamic Banker Data Base
3- Wiki Finance

4 Difference between Islamic and Conventional Banking [4]

Characteristics	Islamic Banking Systems	Conventional Banking Systems
Business Frame Work	Based on Sharia laws- Sharia scholars ensure adherence to Islamic laws and provide guidance.	Only secular banking Laws.
Balance between moral and material requirement	The requirement to finance physical assets which banks usually take ownership of before resale reduces over extension of credit.	Excessive use of credit and debt financing can lead to financial problems.
Equity Financing with risk to capital	Enables several parties including Islamic bank to provide equity capital to a project venture. Losses are shared on the basis of equity participation while profits are shared on basis of pre agreed ratio. Management of the enterprise can be of several forms depending on whether financing is through Mudarabah, Musharaka etc.	Not Generally available through commercial banks, but through capital companies and investments banks, which typically take equity stakes and management control on an enterprise for providing start-up finance.
Prohibition of Gharar	Transaction deemed Gharar are prohibited. Gharar denotes varying degrees of deception pertaining to the price and quality of goods received by a party at the expense of the other. Derivatives trading e.g. options are considered as having elements of Gharar.	Trading and dealing in derivatives of various forms are allowed.
Profit and Loss Sharing	All transactions are based on this principal. Returns are variable, dependent on bank performance and not guaranteed. But the risk are managed to ensure better returns than deposit accounts. Consumers can participate in the profit upside i.e. in a more equitable way than receiving a predetermined return	This principal is not applied. Returns to depositors are irrespective of bank performance and profitability. The customers as a depositor is like a lender and does not share in the success of enterprise beyond receiving a fixed rate of predetermined interest.

3- Abu Dhabi Islamic Bank

Overcharged	The Islamic banks have no provision to charge any extra money from the defaulters. Only small amount of compensation and these proceeds is given to charity. Rebates are given for early settlement at the Bank's discretion.	It can charge additional money (penalty and compounded interest) in case of defaulters

5 The Governing body or Shariah Board.

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

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

5.1 AAOIFI A not-for-profit organization that was established to maintain and promote Shariah standards for Islamic financial institutions, participants and the overall industry. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was created on February 26, 1990 to ensure that participants conform to the regulations set out in Islamic finance.

The founding and associate members, as well as the regulatory and supervisory authorities of the AAOIFI, define the acceptable standards for various functions. This includes areas such as accounting, governance, ethics, transactions and investment

5- aaoifi.com/

6 Future Challenges of Islamic Finance.

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

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

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

Most importantly, the awareness, understanding and availability of Islamic finance needs to be improved within the Muslim communities themselves. There remains a danger if the Muslims do not take up these products, then those stand alone institutions could end up offering a product where there are no clients. Those relying on the windows of global banks could see their Islamic product ranges be withdrawn due to very low take-up or lack of understanding of how they work.

IFEC's work is to raise awareness of Islamic Finance so Muslims can start to understand the importance it has within Islam. The journey to change will not be completed overnight, but it can certainly begin in the knowledge the journey could take years, even a generation to complete.

Compromising Principals Islamic economics is not the exclusive preserve of Muslims.
London is emerging as a major financial centre for Islamic finance. Islamic banking products are also widely used by non Muslims in Malaysia.
.
"This is an alternative system that can be applied to everybody. Everybody can use it regardless of their religion," says Dr Brodjonegoro from the Islamic Development Bank.
Major banks like Britain's HSBC and Citi of the US have set up Islamic banking subsidiaries that are flourishing. Some of the champions of the Islamic way want to see business expand beyond the natural market of Muslim countries.
They believe that now, more than ever, there is a market for non Muslims who share in the values espoused in Islamic economics. But there are some who fear that by expanding the Islamic way is becoming less Islamic.

6- news.bbc

7 Conclusion Summary

Islamic financial institutes despite the successful acceptance there are problems. These problems are mainly in the area of financing itself.

There are many things that I can say about Islamic finance that give hope for its future as an alternative for conventional finance, but 'simplicity' is not one of them. There are places where there could be more simplicity (e.g. post-AAOIFI ruling mudaraba sukuk) where assets with stable distributions could be pooled to create a product that offered an alternative to conventional bonds. However, this is not the direction the industry is going. Instead the product mix (and sukuk in particular) are becoming increasingly complex instruments, although thankfully not as complex as some of the pre-financial crisis issuance like the Nakheel- (Dubai based Real estate developer) Pre-IPO convertible sukuk.

With only minor changes in their practices, Islamic banks can get rid of all their cumbersome, burdensome and sometimes doubtful forms of financing and offer a clean and efficient interest-free banking. All the necessary ingredients are already there. The modified system will make use of only two forms of financing -- loans with a service charge and *Mudaraba* participatory financing -- both of which are fully accepted by all Muslim writers on the subject.

Such a system will offer an effective banking system where Islamic banking is obligatory and a powerful alternative to conventional banking where both co-exist. Additionally, such a system will have no problem in obtaining authorisation to operate in non-Muslim countries.

Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is an additional service Islamic banks offer over and above the traditional services provided by conventional commercial banks.

7- Drawn from Zawya blogs

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