

Islamic Finance



Bsc Amil Aliyev

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1. General overview

Over the last century multiple crises arose which thereby devastated global and local financial systems that challenged the reliability and even existence of them. Unfortunately, there were no tailor-made anti-crises mechanism to prevent the occurrence those crises. It is obvious that world community absorbs brand-new ideas and trends more greedily than past. Islamic Finance is one of this trends that is developing at stable pace, despite simultaneously significant growth of Islam phobia in Western world. According to the some authors, the main features of Islamic finance allows to develop anti-crises mechanism. Maybe it is just a new and temporary trend or maybe the rescuer that will bring financial discipline to the markets but I think we are not be able to assess it now or in near future.

2. The scope of Islamic finance

The *General Council for Islamic Banking and Finance Institutions* (GCIBFI) reports that roughly 200 *Islamic financial institutions* (IFIs) operating in 48 countries (El-Hawary and others, 2004) hold more than US\$300 billion in assets under management. The Islamic finance sector has been estimated to grow by more than 15 percent per year and the expectations are for this growth to continue in the foreseeable future. In the wake of rapid growth in cash markets and first conventional structured credit transactions since 2003.

3. Basic features of Islamic Finance

The basic principle in the Sharia Islamic Common Law. Is that exploitative contracts based on Riba interest or usury. or unfair contracts that involve risk or speculation Gharar are unenforceable. However the Holy Quran contains no condemnation of morally acceptable investments that yield fair legitimate profits and economic social “added-value” (Siddiqi 1999.) Two more principles are fundamental to understanding Islamic finance. First, the Islamic law reflects the totality of Allah’s commands that regulate all aspects of the life of a Muslim. Second, Islamic finance is directly involved with spiritual values and social justice Muslims from taking out mortgages, carrying balances on credit cards or investing in any fixed income securities such as T-bonds, T-Bills, CDs or any other financial security that promises a guaranteed return. This does not imply that Islam frowns on making money or demands that Muslims revert to an all-cash or barter economy, but means that all parties to a financial transaction share the risk and profit or loss of a venture, and that no one party to a financial contract gets predetermined return. For example, “depositors” in Islamic banks are really shareholders who earn dividends when the bank turns a profit, or lose a portion of their savings if it posts a loss. In effect, the Islamic financing functions much like Western equity financing. Investors and lenders have the right to a decent rate of return; it is just the certainty of the return that is an issue. This direct correlation between investment and profit differentiates Islamic banking from conventional or western banking, which defines maximization of the shareholders’ wealth as the sole objective of the firm.

Investments or finance is targeted to the specific needs of an entity. There is not much room for raising a variety of unsecured debts that are not targeted to the specific needs of borrowers. Conventional Western financing, on the other hand, lacks a corrective mechanism to stop excessive borrowing beyond individual companies’ means. In good times, raising funds is

easy, while in bad times the cost of raising funds is high; therefore, the risk to the financing institution is increased. The amount of borrowing under a conventional system is several times more than it would be under an Islamic system, and so are the risks inherited from these excessive borrowings.

3. Islamic Financial Instruments

Islamic banks through the use of two broad classes of instruments: profit and loss sharing (equity-like) contracts and mark-up (debt-like) contracts. Finally, Islamic finance law prohibits investment in certain industrial sectors whose products are of questionable moral value, including, for example, the alcohol, gambling, and sometimes the tobacco industries.

The main equity-like contracts used in Islamic finance are:

Modoraba: an agreement made between a party which provides all of the capital for a project and another party, the modarib, or entrepreneur- project manager. Profits from the project are distributed according to a pre-determined sharing ratio but any losses are borne solely by the provider of capital. The provider of the capital has no control over management of the project.

Musharaka: A financing technique involving a partnership between parties who provide capital towards the financing of a project. The parties share profit on a preagreed ratio, but losses are shared on the basis of equity participation. One or more parties can carry out management of the project.

The main mark-up (debt-like) contracts used in Islamic finance are:

Murabaha: A contract between the financial institution and its client for the sale of goods at a price that includes a profit margin agreed by both parties. As a financing technique, it involves the purchase of goods by the financial institution as requested by its clients. The goods are sold to the client with a mark-up. Repayments, Usually in installments, are specified in the contract.

Zjara: A leasing contract under which a financial institution buys and leases out for rental fee equipment required by its clients. The duration of the lease and rental fees are agreed in advance. Ownership of the equipment remains in the hands of the financial institution. The contract is a classical Islamic financial one, now in increasing use worldwide and identical to a full-payout financial lease.

Zjara wa Zktina: A leased hire purchase contract similar to Zjara, except that there is a commitment from the client to buy the equipment at the end of the rental period. It is agreed that at the end of the lease period, the client will buy the equipment at an agreed price from the financial institution, with rental fees previously paid constituting part of the price.

Zstisna: A contract for acquisition of goods by specification or order, where the price is paid progressively in accordance with the progress of a job completion. This is practiced, for example, for purchases of houses to be constructed where payments made to the developer or builder is according to the stage of work completed.

4. Islamic Insurance (takaful)

Takaful is considered as an Islamic equivalent of conventional insurance that has been complied with the principles put forward in Shariah law. Saudi Arabia and Malaysia are considered as the major markets for Islamic insurance industry. The term itself is of Arabic origin

(al-kafala) and means “joint benefit” or “shared responsibility” which is above and beyond all is in the core principles of Islam. More explicitly, it is “a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose” that “do not involve any element which is not approved by the Shariah” (Takaful Act 1984, sec 2). This is why this aqd (contract) in essence is bound to be policyholder-oriented rather than shareholder-oriented (Kwon 2007: 62). That is, in the shareholder-oriented agreements the agency conflicts and information asymmetries dominate, whereas in takaful aqds the interests of the policyholders are built not to clash with one another but to cooperatively pool their resources (ta’awun) and risks for common benefit. Here the pre- and post-contract information asymmetry problems such as adverse selection and moral hazard are further reduced in terms of pecuniary subscription and compensation issues which will be further explicated under different models built upon them (Wahab et al. 2007).

Mudharabah .

It is the model where the takaful operator or entrepreneur shares profit on investment and the surplus on underwriting with the insured parties in a predetermined ratio when the firm makes profit, but attain nothing in the times of loss. In other words, the takaful operator obtains the “contributive” capital termed as rabb-al-mal from the policyholders who are called sahib-ul-mal, in return to mudharib which is/are the business service(s) provided by the operators within the conditions of ijab and qabul. At times of loss, the deficit in the fund is covered with Qard al-Hasan by equity holders of the insurance firm. In return this benevolent interest-free loan is reimbursed by the policyholders during the times of surplus in the fund. Every year, the profit/surplus sharing rations are determined between the policyholders and operators before being approved by the Shariah Committee (Billah 1998, Agha, 2010 and Qureshi, 2011).

Wakala.

This model differ from mudharabah, as here participants hire the takaful operator in the quality of an agent or wakeel to manage their funds, in return who requests the fixed performance fee called wakala fee from participants instead of sharing profit or surplus in predefined ratio which was in the case of mudharabah (Agha, 2010 and Qureshi, 2011). However there are retakaful cost, technical and claim reserves, unearned subscriptions etc. which are then deducted from takaful fund after the transfer of wakala fee to the equity holders’ account. The remaining part is called surplus and then some share of it might be kept in contingency reserve for the protection of future losses and another share is allocated to the policyholders proportionately to their subscriptions

5. Islamic Investment Certificates (Sukuk)

Although the religious prohibition of the exchange of debt and the required conferral of ownership interest to participate in business risk still poses challenges to further development of Islamic securitization, the gradual acceptance of Islamic investment certificates, so-called sukuk.

Sukuk represents undivided shares in the ownership of tangible assets relating to particular projects or special investment activity. A sukuk investor has a common share in the ownership of the assets linked to the investment although this does not represent a debt owed to the issuer of the bond.

6. Islamic Theory of Finance and the Global Financial Crisis

The 1988 Nobel Prize winner, French economist Maurice Allais foresaw the inevitability of the current structural global economic crisis and warned against its consequences. He categorically argued that the way out of such crises is best achieved through structural reforms that go far beyond addressing the symptoms of the crises to devising an efficient monetary system that is truly capable of preventing such crises from happening in the future. The two basic components at the heart of the proposed system are adjusting the rate of interest to 0% and revising the tax rate to about 2%. Incidentally, these are the core elements of Islamic economics; Islam prohibits interest (riba) and requires all Muslims who possess minimum net worth above their basic needs (Nisab) to pay Zakah (2.5% of the assets that have been owned over a year). Zakah is a major economic instrument premeditated to spread socioeconomic justice among Muslims. Unsurprisingly, the US reserve has just announced the cut in the lending rate to be between 0% and 0.0025%, and the demand for meaningful tax cuts is building up.

Shariah-compliant banking proposes uncompromising moral guidelines for dealing with money. The supply of money must be proportionate with the prospects of real growth in the economy in order to provide for a sustainable development and more equitable distribution of wealth. A host of intellectuals are forcefully arguing for the return to some “form of commodity” (i.e., gold) currency peg in order to reinstate value for money and streamline its supply. The printing of trillions of dollars and other currencies without proper backing in an attempt to restore a sense of economic equilibrium will undoubtedly lead to a much higher inflation rate due to excessive liquidity and large deficits in fiscal and monetary policies, and will eventually drive interest rates to new heights, as central banks endeavor to restrain excessive spending.

Islam prohibits paying or receiving any predetermined fixed rate of return on borrowed/lent money.

Charging interest (riba) tends to drive the poor into more poverty and create more wealth for the wealthy without doing work or sharing the risk involved in every business undertaking. Riba further creates wealth without actually being the outcome of productive economic activity or as the result of an increase in commodity supply.

“**Rent-seeking activity**” such as charging interest creates new but artificial capital, which is by no means the lifeblood of the markets. Ahmad (1996) pointed out, “The essence of the market is entrepreneurship” and explained that “trade, not banking is the primary function of markets.”

“**No pain, no gain**” embedded in the Islamic financial structure entails that no one has the right to rewards (profit) if they do not equally share the risk of incurring loss. Chapra (2009) believes that this concept “should help introduce greater discipline into the financial system.”

7. Problems and challenges

Lack of Standardization

Interpretations of Islamic Shariah principles are left to Muslim scholars. Hence, different schools of thought have emerged in different cultures and Islamic societies. For example, there is no agreement among different schools of thought on whether riba and interest are synonymous

terms. Lack of standardization is not only time-consuming and costly, but it also leads to confusion about what Islamic banking really encompasses.

Regulation and Legislation

Islamic banking system has only recently emerged, regulatory and supervisory techniques have not yet been developed to accommodate Islamic banks. One of the major problems facing the development of Islamic banks is the current legal structure. The inability of Islamic banks to guarantee deposits or returns makes it difficult for the Bank of England to consider them as banks

Tax Discrimination

Alternative to interest under the Islamic banking system, is not tax-deductible (Temple, 1992). Most Islamic banks and financial institutions resent this extra burden and call for just regulation for both systems.

Liquidity and Risk Management

According to Mudawi (1986), no money market for Islamic funds exists, and there is no interbank where the Islamic bank can place their funds overnight or obtain loans for short-term liquidity needs. The lack of liquidity instruments is one of the primary difficulties that Islamic financial institutions have faced. Without access to liquidity instruments, Islamic banks and financial institutions will continue to have liquidity shortages. This problem is exacerbated by the lack of support from central banks as a lender of last resort. It is obvious that without the support of the respective central banks, further development will be extremely difficult. In this respect, Dudley (1997) showed that the lack of capital markets and marketable instruments moved a significant proportion of the Middle East wealth abroad or kept part of the wealth invested in the property sector. On the other hand, some attempts have been made by the Malaysian central bank to set up an Islamic interbank and capital market systems.'

Conclusion

Despite mild environment and moral-based financial system , on my opinion, Islamic Finance is not seem to replace the major features of international financial systems. Probably because of the short history and crises-avoiding features, IF will continue grow with stable pace. Nevertheless , further institutional and legislative problems will arise during the expansion period which can force the Islamic Financial authorities to make some radical changes that would neglect or divert from the real nature of IF. I am definitely sure that IF is looking for further paths that is not mentioned in “Holy Quran” to improve and expand.

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