UNIT-1

Introduction to Islamic Banking

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Recognize the Theoretical Basics of Islamic Banking
- ✓ Identify the Prohibition of "Riba" & "Gharar" in Islam
- ✓ Assess the Islamic Financial Contracts
- ✓ Explore the Financial Services Offered by Bank

Unit 1

Introduction to Islamic Banking

Introduction

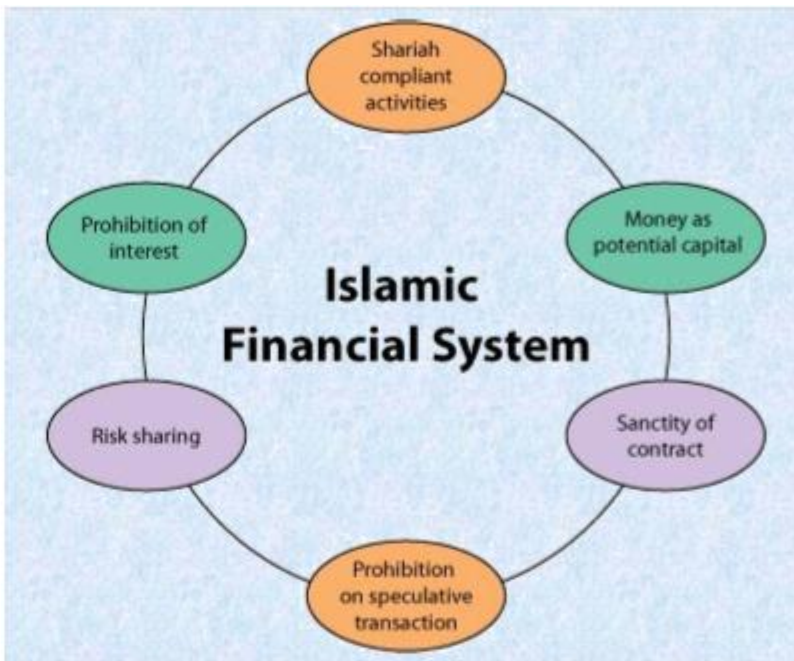
Today Islamic banking has expanded to become a distinctive and fast growing sector of the international banking and capital markets. There are well over 200 Islamic banks operating in over 70 countries comprising most of the Muslim world and many Western countries. Not included in these figures are the 50 Islamic insurance (*takaful*) companies operating in 22 countries, Islamic investment houses, mutual funds, leasing companies and commodity trading companies. Also excluded are the very largest Islamic banks engaged at a multilateral level. To these numbers must be added the many hundreds of small Islamic financial institutions such as rural and urban cooperative credit societies, Islamic welfare societies and financial associations operating at a local level and dealing with rural entities, small business firms and individual households.

Industry growth has averaged 10 to 15 per cent a year and sniffing opportunity, conventional banks like Citibank and Hongkong & Shanghai Banking Corporation (HSBC) have opened Islamic "windows" in the Gulf. And whilst the industry's market share is still modest — about 10 per cent in Bahrain — its very existence challenges the modern assumption that global capitalism flattens all before it. According to Fouad Shaker, secretary general of the Union of Arab Banks, there are over 265 Islamic financial institutions in the world with capitalisation in excess of US$13 billion and assets of over US$262 billion. The key feature, or principle, that distinguishes Islamic banks from any other kind of bank is the rejection of interest-based financial transactions. The Quran's ban on giving or receiving interest is known to all devout Muslims. The words from Chapter 2, Verse 278 of the Quran are, in fact, quite specific: **"O you who believe! Have fear of Allah and give up what remains of what is due to you of usury If you do not, then take notice of war from Allah and His Messenger."**

Islamic scholars believe this system is superior on several counts. It leads to more prudent lending, they say, by encouraging financiers to invest directly in an entrepreneur's ventures. "A financial system without interest is more interested," says Shaykh Yusuf DeLorenzo (a Virginia-based Islamic scholar). Accordingly the scholars believe that interest-free finance would also prevent future Enrons and Argentinas. "One reason for prohibiting interest is to keep everybody spending according to his limit," says Yaquby. "This consumerism society was only created because of the banking system, because it encourages 'buy today, pay tomorrow'. You also have poor economies in debt to rich ones. This is because of borrowing and lending with interest. So this is creating big economic chaos in the world." An Islamic banking and financial system exists to provide a variety of religiously acceptable financial services to the Muslim communities. In addition to this special function, the banking and financial institutions, like all other aspects of Islamic society, are expected to 'contribute richly to the achievement of the major socio-economic goals of Islam'.

At the beginning of the twenty-first century, many Western, Middle Eastern and Asian financial institutions recognise Islamic banking as an important new opportunity for growth and have adopted Islamic practices to serve this expanding market. Islamic mutual funds have also sprung up which invest client monies in ways that do not conflict with the conscience or practical interests of Muslims. In this respect they are rather like socially responsible funds in the West. The prohibition of interest — the ethical core of Islamic banking — derives from Islamic law, which is enshrined in the Shari ‘a.

The word shari'aliterally means a waterway that leads to a main stream, a drinking place, and a road or the right path. It is a term that encapsulates a way of life prescribed by Allah (GOD) for his servants and it extends to every department of daily life, including commerce and financial activities of every kind.



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This rejection of interest by Islam poses the question of what replaces the interest rate mechanism in an Islamic framework. If the paying and receiving of interest is prohibited, how do Islamic banks operate? Here PLS comes in, substituting profit-and-loss-sharing for interest as a method of resource allocation. Although a large number of different contracts feature in Islamic financing, certain types of transaction are central: trustee finance (mudaraba), equity participation (musharaka) and ‘mark-up’ methods. Some of these profit-sharing arrangements such as mudaraba and musharaka almost certainly pre-date the genesis of Islam.

Business partnerships based on what was in essence the mudaraba concept coexisted in the pre-Islamic Middle East along with interest loans as a means offinancing economic activities.

Following the birth of Islam, interest-based financial transactions were forbidden and all finance had to be conducted on a profit-sharing basis. The business partnership technique, utilizing the mudaraba principle, was employed by the Prophet Muhammad (PBUH) himself when acting as agent (mudarib) for his wife Khadija (RA), while his second successor Umar ibin al-Khattab (RA) invested the money of orphans with merchants engaged in trade between Medina and Iraq. Simple profit-sharing business partnerships of this type continued in virtually unchanged form over the centuries, but they did not develop into vehicles for large-scale investment involving the collection of large amounts of funds from large numbers of individual savers.

This development did not happen until the growth of Islamic financial institutions. Islamic financial products need to be more than offered to customers, they need to be actively marketed. For those Islamic banks operating in fully Islamicized financial systems this may not be needed. For those in mixed financial systems it is certainly the case. When these banks were initially established, they relied heavily on their religious appeal to gain deposits. This emphasis has continued. To give one example, Saeed (1995) reports that the Faisal Islamic Bank of Egypt (FIBE) is actively involved in attracting Muslims, particularly those who believe in the unlawfulness of interest, to its deposit mobilization schemes. To attract such customers in an increasingly competitive financial environment, FIBE utilizes several means:

- Encouraging leading ‘ulama (religious scholars) to propagate the prohibition of interest;
- Emphasizing its Islamic credentials by means of the collection and distribution of Zakat;
- Convening seminars and conferences to propagate the merits of Islamic banking;
- Offering modern banking facilities such as automatic teller machines and fast banking services by means of installing the latest computer technology in banking operations;
- Giving depositors a return comparable to that given to the depositors of traditional Banks;

Theoretical Foundations of Islamic Banking

Why Islamic banking: the rationale

Banks are the most important financial institutions in a modern economy. They perform some very important functions for society and in this process significantly influence the level of economic activity, the distribution of income and the level of prices in a country. Although initially the major function of banking was to mobilize savings and transfer them to entrepreneurs, over time they have come to perform a number of other functions as well. In addition to offering their services for safe custody of money and other valuables, they also offer current account facilities, easy transfers of money, letters of guarantee, payment of utility bills, and loans for consumer durables and investment. As a result of developments such as credit cards, automated teller machines (ATMs), repurchase accounts, and so on, it has become very easy to make payments through banks. Therefore, in a modern economy, a very large part of current incomes are deposited with the banking system. Due to the facilities mentioned above, people do not need to physically withdraw their money nearly as much as they used to. As will be discussed later, this phenomenon enables the banks to 'create' money on their own. This feature increases banks' influence over an economy. The functions that the banks perform are very important, and an Islamic economy cannot operate without these functions. Consequently, Islamic scholars have dealt with the theoretical foundations of banking activities with a view to finding alternatives.

The functions of financial systems are the same whether these relate to developed or less developed economies, or to Islamic or conventional economies.

Four key roles are performed in a financial system. First, it provides financial intermediation services, channelling funds from ultimate savers to ultimate borrowers.

Second, the system provides a wide range of other financial services not immediately related to financial intermediation: payment services, insurance, fund management, and so on.

Third, it creates a broad array of assets and liabilities, each of which have different characteristics with respect to, for instance, liquidity, maturity, the type of return generated, and risk-sharing.

The fourth central role of any financial system is the creation of incentives for an efficient allocation of resources within an economy, and the allocation of scarce financial and real resources between competing ends. These key roles of the financial system are not specific to conventional or Islamic-based systems; it is in how these roles are performed that differences arise. This can be illustrated by giving some examples.

The function of financial intermediation requires providing mechanisms for saving and borrowing so that agents in the economy can alleviate budget constraints. This involves creating a variety of financial assets and liabilities with different characteristics that appeal to different savers and borrowers. Conventional commercial banks provide financial intermediation services on the basis of rates of interest (charged and paid) on both the assets and the liabilities side. Since interest is prohibited in Islam, Islamic banks have developed several other modes through which savings are mobilized and passed on to entrepreneurs, none of which involves interest. Similarly, for performing the function of providing other financial services, such as payment services, insurance, fund management and so on, Islamic banks have developed alternative contracts which are compatible with the shari'a.

The third and fourth common functions require the creation of a wide variety of instruments and incentives for an efficient allocation of scarce financial and real resources between competing ends. An efficient allocation of resources requires an accurate assessment and efficient pricing of risk. Somehow, the price of finance needs to include an allowance for the risks involved. Similarly, the rates of return to the suppliers of finance should also reflect the risks taken. Once again, in conventional systems a major route for this is through the rate of interest with risks of alternative projects or loans being reflected in different risk premia incorporated in the interest rates on different loans. Clearly, this route is not relevant in Islamic finance, which means that alternative mechanisms are needed. However, it must be noted here that the prohibition of interest in Islam does not mean that capital is not to be rewarded or that risk is not to be priced.

Principles of Islamic finance: the basis

In Islamic jurisprudence there are two kinds of *ahkam*(rulings). The first kind, called *ibadat*(worship), governs the relationship between man and God. The general principle in the case of *ibadat* is that nothing is permitted unless covered by explicit or analogical permission by the Law Giver. In other words, an act is considered worship only if so ordained.

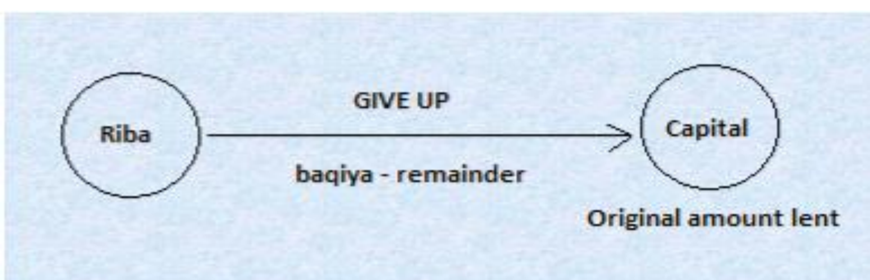
The second kind of ahkam, called mu amalat (mutual dealings), governs the relationship among mankind. In this case, the general principle is that of ibahah (permissibility): that is, everything is permitted unless clearly prohibited by God. We call this the 'Doctrine of Universal Permissibility'. There are very few kinds of activity that are prohibited. The purposes of such prohibitions are to provide a level playing field to protect the interests of weaker parties, to ensure justice and fairness and in general to ensure mutual benefit for the parties as well as society at large, and to promote social harmony.

In addition to the Doctrine of Universal Permissibility, Islam permits the contracting parties to agree on any conditions as long as they do not violate any Shari'aruling. There is a well-known authentic hadith which states: 'All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful' (Sunan Abu Dawood). We call this the 'Golden Principle of Free Choice'. As may be seen, this principle gives a very wide scope for designing contracts. In the following paragraphs we discuss the few prohibitions that are most relevant for constructing financial contracts.

Prohibition of '*Riba*'

Definition of '*Riba*'

In its basic meaning, riba can be defined as 'anything (big or small), pecuniary or non-pecuniary, in excess of the principal in a loan that must be paid by the borrower to the lender along with the original loan'. According to a consensus of *fuqaha'* (Islamic jurists), it has the same meaning and import as the contemporary concept of interest.



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Reasons for prohibition

Even though there is no explicit statement in the Qur'an and/or Sunnah giving the rationale of prohibiting *riba*, Islamic scholars provide a number of reasons for its prohibition. Siddiqi (2004), for instance, singles out five such reasons: *riba* is unfair; *riba* corrupts society; *riba* implies improper appropriation of other people's property; *riba*'s ultimate effect is negative growth; *riba* demeans and diminishes human personality.

Among the most important reasons that have been emphasized by most writers is that interest is prohibited because it is unfair (*zulm*). A contract based on interest involves injustice to one of the parties, sometimes to the lender and sometimes to the borrower. The *riba* contract is unjust to the borrower because if somebody takes a loan and uses it in his business, he may earn a profit or he may end up with a loss. Now, in the case of loss, the person using that money (let us call him the entrepreneur) loses his labour. In addition to this loss, he has to pay interest and the capital to the lender. The lender, or the financier, in spite of the fact that the business has ended up making a loss, gets his money as well as his interest; therefore it is unjust.

Now, let us see how sometimes interest contracts can be unjust to the lender. In most of the underdeveloped world, and even in many developed countries, most of the borrowers today are large companies. They pay, let us say, a 10 per cent or 15 per cent rate of interest on their loans. We know that if the rate of inflation is higher than that, then the real rate of interest becomes negative. The lenders, surplus units, are usually small savers like you and me. Banks collect the savings of all small savers and pass them on to the industrialists who may earn a rate of 50–100 per cent profit but pay back only 10–15 per cent in the rate of interest, which in a real sense is not even equivalent to the rate of inflation. Based on that rate of interest and of course minus the administrative expenses of the bank and their own margin, the banks pass on the difference to the lenders in the form of interest paid on deposits. This is why the banks give very small rates of return to small savers. In an inflationary environment the real rate of interest is even negative. Therefore, had these savings been invested on the basis of profit-sharing, and then small savers would have obtained much better returns.

Interest also has many adverse consequences for the economy. In a sharing system, the productivity of the project is more important. Therefore, the finances go to more productive projects. In this way, instead of resources going to low-return projects for borrowers with better credit-worthiness, bank lending is more likely to flow to high-return projects even if the credibility of the borrower is somewhat lower. Therefore, the system is more efficient in the allocation of resources. It is also more efficient because the return to the bank is now linked to the success of the project.

In the interest based system banks do not have to care as much about project evaluation since they obtain a return on their loans irrespective of the success of the project. Also, in Western banking, if security is provided then a return is guaranteed (or at least part guaranteed) even if the project is a disaster. While conventional banks, of course, make losses, the argument is that interest-based systems force borrowers to continue to repay loans even when their circumstances are ill-suited to making such repayments, ultimately exacerbating the problem and resulting in default. Interest-based banking systems therefore may accentuate downturns in the business cycle.

Western views on interest

The practice of interest has been condemned by foremost thinkers in human history and by all divine religions. Under Judaism, Israelites were forbidden to demand any increase on the principal amount of the sum lent in transactions among themselves, although interest could be charged in dealings between Israelites and gentiles: 'Do not charge your brother interest, whether on money or food or anything else that may earn interest. You may charge a foreigner interest, but not a brother Israelite.'

The reason for this distinction, according to many scholars of Judaism, was that there was no law at that time among the gentiles which prohibited the practice of interest, and it was not regarded as unfair that Jews be allowed to recover interest from people who charged interest from them.

In Christianity, the reported saying by Christ to 'lend freely, hoping nothing thereby' (Luke 6:35) is taken by many commentators as a condemnation of interest. However, the Church gradually changed its doctrine on the subject of interest. In any case, the divorce between religion and mundane affairs accepted by Christian societies after **the** Renaissance opened the door to a widespread practice of interest.

Mills and Presley (1999) have traced the history of prohibition of interest in Biblical texts and Western literature. Their findings can be summarized as follows:

1. Until approximately 1050, interest-taking was considered by the Church to be a sign of greed and lack of charity.
2. The harshest anti-usury Church legislation was passed by the Council of Vienna (1317). This not only called for the excommunication of usurers but also that of any ruler who sanctioned usury. To declare that interest taking was not a sin was classed as heresy.
3. Within Catholic Europe, the usury prohibition continued to have some practical force until the late eighteenth century. (The Vatican only formally recognized the legitimacy of interest in 1917.6)
4. In England, the last Act condemning all interest as contrary to God's law was passed in 1571.
5. From 1600 onwards, the debate was transformed from whether to proscribe interest altogether, to which rate it was most expedient to have as a legal maximum. Bowing to agrarian interests, the UK Parliament gradually reduced the legal maximum to 5 per cent by 1714.
6. Ultimately, the debate shifted to whether a legal maximum could be justified at all: for instance, Adam Smith supported the restriction of interest rates to just above the normal market rate.
7. It was Jeremy Bentham who argued in favour of interest. His arguments eventually carried the day. In Britain, the 1854 Money Lenders' Act abolished the 5 per cent usury law and allowed lenders to charge any rate. A limit of 48 per cent was re imposed in 1927 in an attempt to protect vulnerable borrowers. However, since the passage of the Consumer Credit Act (1974), no such restriction exists.

Prohibition of ‘*Gharar*’

The second important prohibition in exchange contracts is that of *gharar* trading. This prohibition is based on authentic *ahadith* of the Prophet (peace be upon him). Reliable sources have reported through a number of the Prophet’s (PBUH) companions that the Prophet(PBUH) has forbidden *gharar* trading. Literally, *gharar* means to unknowingly expose oneself or one’s property to jeopardy. In jurisprudential literature, *gharar* has been variously defined.

Definition of *gharar*

Gharar refers to acts and conditions in exchange contracts, the full implications of which are not clearly known to the parties. This is something very similar to ‘asymmetric information’. There are two kinds of gharar: gharar fahish (substantial) and gharar yasir (trivial). The first kind is prohibited in Islam while the second is tolerated since this may be unavoidable without causing considerable damage to one of the parties.

In many cases, it is simply not possible to reveal all information (not because the seller wants to hide anything, but because it is in the nature of the product). The buyer has to trust the seller. For example, the buyer of a built house has to take the word of the seller as to what kind of material has been used in the foundations of the house. The seller obviously cannot dismantle the house to reveal the foundations to the buyer. Therefore, such lack of knowledge does not violate contracts. The principle in such cases is that the seller must act as a trustworthy person. Penalties may be imposed ex post if it is proved otherwise.

Basically, riba and gharar are the only two prohibitions that have to be kept in view in financial contracts. Some other conditions are also mentioned sometimes (for example, prohibition of selling something before owning it, but that is really covered by the prohibition of gharar).

However, one special prohibition within the category of gharar may be noted separately, and that is maysir (gambling).

Prohibition of ‘maysir’

Islam prohibits all kinds of gambling and games of chance. This is based on clear texts in the Qur’an. For example:

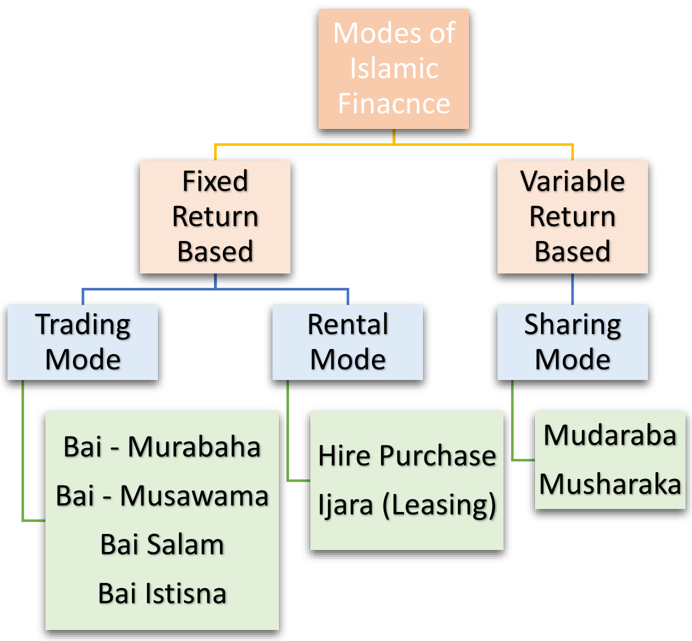
O, you who believe! Intoxicants (all kinds of alcoholic drinks), and gambling, and Al-Ansab (animals that are sacrificed in the name of idols on their altars) and Al-Azlam (arrows thrown for seeking luck or decision) are an abomination of Satan’s handiwork. So avoid that (abomination) in order that you may be successful.

Profit-sharing contracts

Islamic finance has grown rapidly over the last several years, in terms both of the volume of lending and of the range of financial products that are available at institutional and retail levels. The main characteristic of these financial instruments is that they are compliant with the *shari’a*– the Islamic legal system.

The main difference between an Islamic or interest-free banking system and the conventional interest-based banking system is that, under the latter, the interest rate is either fixed in advance or is a simple linear function of some other benchmark rate, whereas, in the former, the profits and losses on a physical investment are shared between the creditor and the borrower according to a formula that reflects their respective levels of participation.

<u>COMMERCIAL MODES OF ISLAMIC FINANCE AND BANKING</u>



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In Islamic finance, interest-bearing contracts are replaced by a return-bearing contract, which often takes the form of partnerships. Islamic banks provide savers with financial instruments that are akin to equity called ***mudaraba*** and ***musharaka.***

In these lending arrangements, profits are shared between the investors and the bank on a predetermined basis. The profit-and-loss sharing concept implies a direct concern with regard to the profitability of the physical investment on the part of the creditor (the Islamic bank). Needless to say, the conventional bank is also concerned about the profitability of the project, because of concerns about potential default on the loan. However, the conventional bank puts the emphasis on receiving the interest payments according to some set time intervals and, so long as this condition is being met, the bank's own profitability is not directly affected by whether the project has a particularly high or a rather low rate of return. In contrast to the interest-based system, the Islamic bank has to focus on the return on the physical investment, because its own profitability is directly linked to the real rate of return.

The direct links between the payment to the creditor and the profitability of the investment project is of considerable importance to the entrepreneur. Most importantly, profit sharing contracts have superior properties for risk management, because the payment the entrepreneur has to make to the creditor is reduced in bad states of nature. Also, if the entrepreneur experiences temporary debt-servicing difficulties in the interest-based system, say, on account of a short-run adverse demand shock, there is the risk of a magnification effect; that is, his credit channels might dry up because of lenders overreacting to the bad news. This is due to the fact that the bank's own profitability is not affected by the fluctuating fortunes of the client's investment, except only when there is a regime change from regular interest payments to a default problem. In other words, interest payments are due irrespective of profitability of the physical investment, and the conventional bank experiences a change in its fortunes only when there are debt-servicing difficulties.

But a temporary cash-flow problem of the entrepreneur, and just a few delayed payments, might be seen to be a regime change, which could blow up into a 'sudden stop' in lending.

In the Islamic model, these temporary shocks would generate a different response from the bank, because the lenders regularly receive information on the ups and downs of the client's business in order to calculate their share of the profits, which provides the important advantage that the flow of information, as indeed the payment from the borrower to the lender, is more or less on a continuous basis, and not in some discrete steps.

For this and other reasons, Muslim scholars have emphasized that profit-and-loss sharing contracts promote greater stability in financial markets. Islamic financial contracting encourages banks to focus on the long run in their relationships with their clients.

However, this focus on long-term relationships in profit-and-loss sharing arrangements means that there might be higher costs in some areas, particularly with regard to the need for monitoring performance of the entrepreneur. Traditional banks are not obliged to oversee projects as closely as Islamic banks, because the former do not act as if they were partners in the physical investment.

Overview of Islamic Financial Contracts

The prohibition of interest (*riba* in Arabic) is the most significant principle of Islamic finance. As a *shari'a* term, *riba* refers to the premium that the borrower must pay to the lender on top of the principal, and it is sometimes put in simple terms as a 'return of money on money' to emphasize the point between interest rate and rate of return on a financial investment: *riba* is prohibited in Islam, but profits from trade and productive investment are actually encouraged.

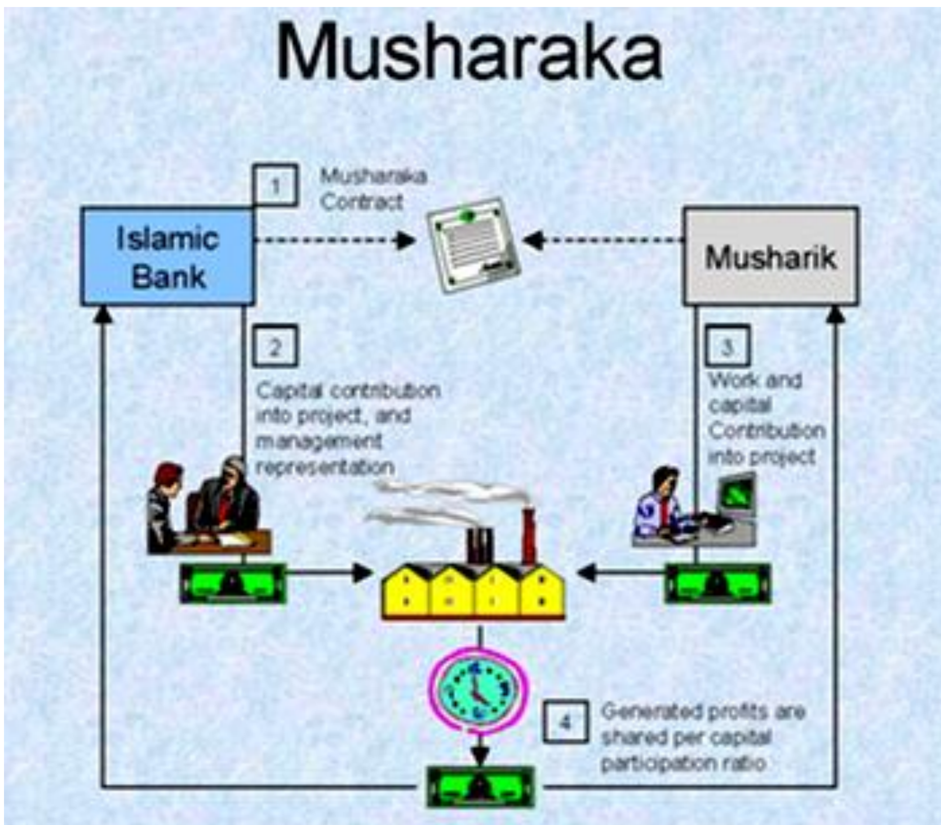
The objection is not to the payment of profits but to a predetermined payment that is not a function of the profits and losses incurred by the firm or entrepreneur. Since the

Islamic financial system stresses partnership arrangements, the entrepreneur and the creditor (bank); alike face an uncertain rate of return or profit. The Islamic financial system is equity-based, and without any debt: deposits in the banks are not guaranteed the face value of their deposits, because the returns depend on the profits and losses of the bank. Thus, on the liability side, depositors are similar to shareholders in a limited-liability company, while, on the asset side, the bank earns a return that depends on its shares in the businesses it helps to finance.

There are certain basic types of financial contracts, which have been approved by various *shari'a* boards as being in compliance with the principles of Islamic finance, which are briefly discussed below:

Musharaka*(partnership)*

This is often perceived to be the preferred Islamic mode of financing, because it adheres most closely to the principle of profit and loss sharing. Partners contribute capital to a project and share its risks and rewards. Profits are shared between partners on a pre agreed ratio, but losses are shared in exact proportion to the capital invested by each party. Thus a financial institution provides a percentage of the capital needed by its customer with the understanding that the financial institution and customer will proportionately share in profits and losses in accordance with a formula agreed upon before the transaction is consummated. This gives an incentive to invest wisely and take an active interest in the investment. In *Musharaka*, all partners have the right but not the obligation to participate in the management of the project, which explains why the profit-sharing ratio is mutually agreed upon and may be different from the investment in the total capital.



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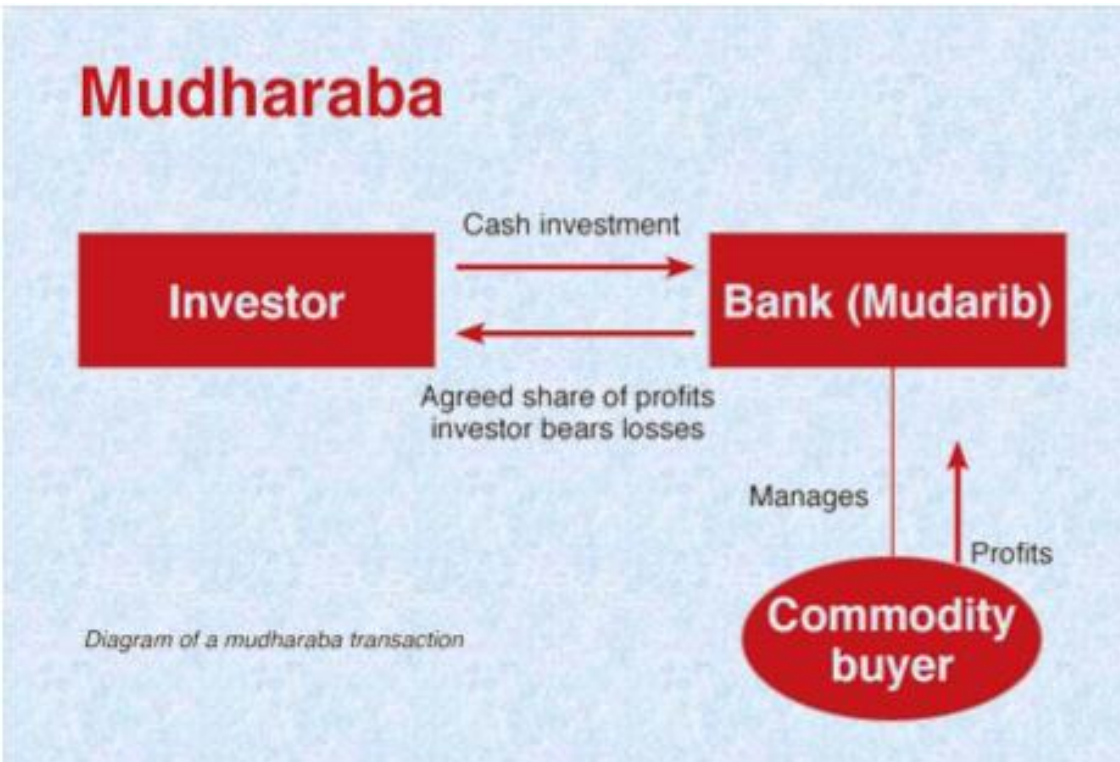
Mudaraba *(finance by way of trust)*

Mudaraba is a form of partnership in which one partner (*rabb al-mal*) finances the project, while the other party (*mudarib*) manages it. Although similar to a *musharaka*, this mode of financing does not require that a company be created; the financial institution provides all of the capital and the customer is responsible for the management of the project. Profits from the investment are distributed according to a fixed, predetermined ratio. The *rabbalmal* has possession of the assets, but the *mudarib* has the option to buy out the *rabb al*-mal's investment. *Mudaraba* may be concluded between an Islamic bank, as provider of funds, on behalf of itself or on behalf of its depositors as a trustee of their funds, and its business– owner clients. In the latter case, the bank acts as a *mudarib* for a fee. The bank also acts as a *mudarib* in relation to its depositors, as it invests the deposits in various schemes.



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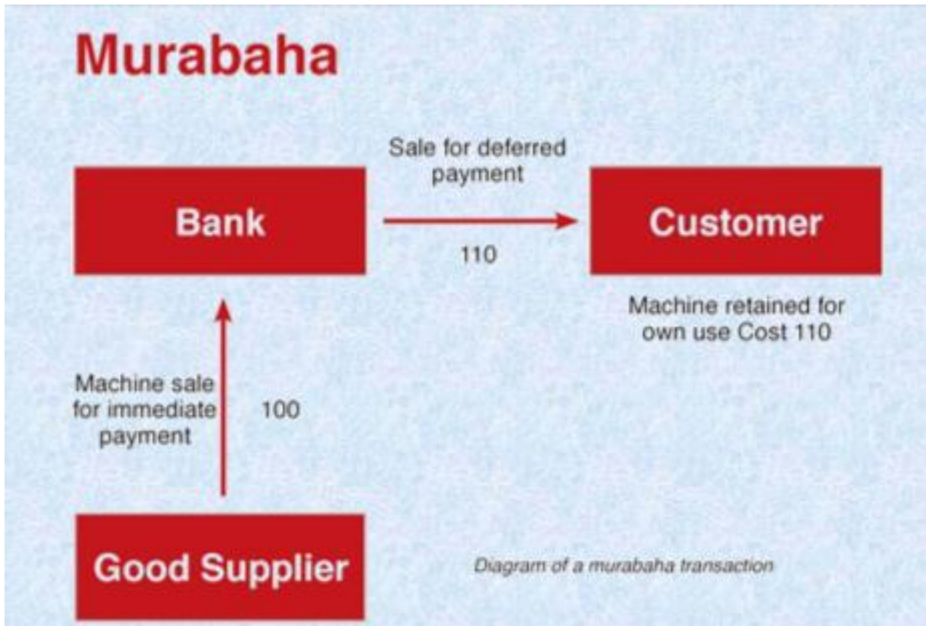
Murabaha (cost-plus financing)

In a murabaha contract, the bank agrees to buy an asset or goods from a third party, and then resells the goods to its client with a mark-up. The client purchases the goods against either immediate or deferred payment. Some observers see this mode of Islamic finance to be very close to a conventional interest-based lending operation. However, a major difference between *murabaha* and interest-based lending is that the mark-up in *murabaha* is for the services the bank provides (for example, seeking and purchasing the required goods at the best price) and the mark-up is not stipulated in terms of a time period. Thus, if the client fails to make a deferred payment on time, the mark-up does not increase from the agreed price owing to delay. Also the bank owns the goods between the two sales, which means it carries the associated risks.



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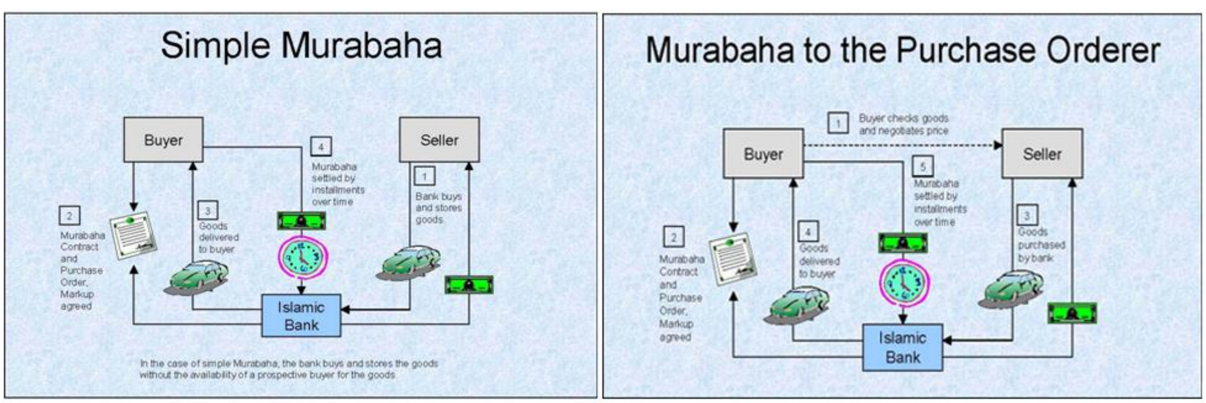

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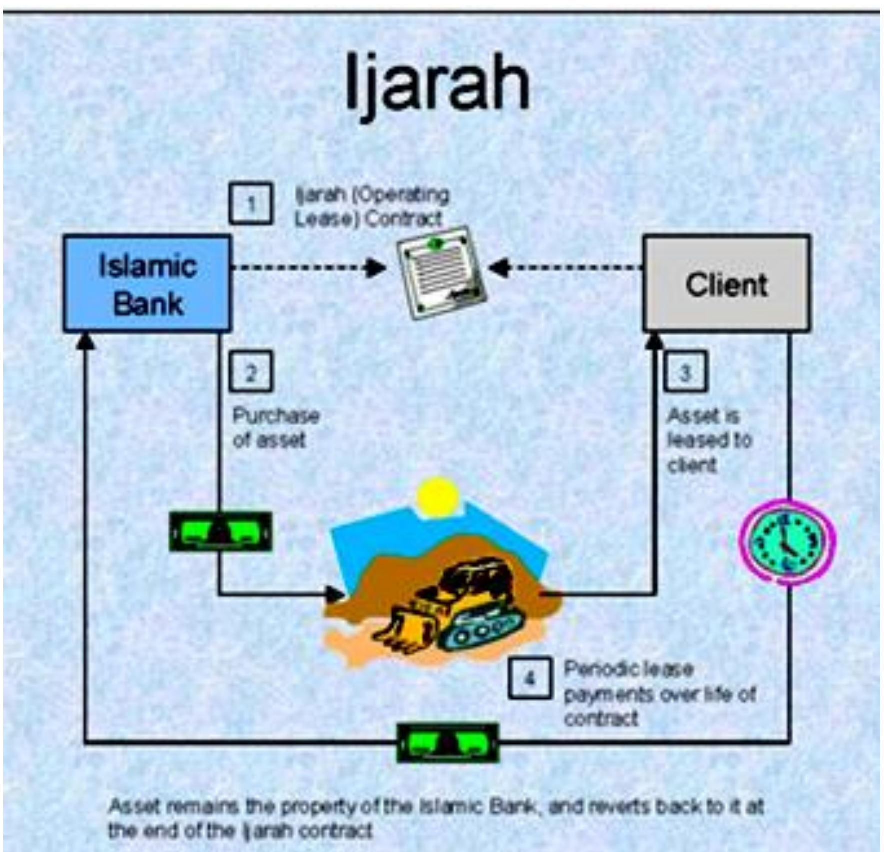
Ijara (leasing)

Like a conventional lease, *ijara* is the sale of *manfa'a* (the right to use goods) for a specific period. In Muslim countries, leasing originated as a trading activity and later on became a mode of finance. *Ijara* is a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee. Responsibility for maintenance/insurance rests with the lessor. During a predetermined period, the ownership of the asset remains with the lessor (that is, the bank) who is responsible for its maintenance, which means that it assumes the risk of ownership. Under an *ijara* contract, the lessor has the right to renegotiate the terms of the lease payment at agreed intervals. This is to ensure that the rental remains in line with market leasing rates and the residual value of the leased asset.

Under this contract, the lessee (that is, the client) does not have the option to purchase the asset during or at the end of the lease term. However this objective may be achieved through a similar type of contract, *ijara waiqtina* (hire-purchase). In *ijara waiqtina*, the lessee commits himself to buying the asset at the end of the rental period, at an agreed price. For example, the bank purchases a building, equipment or an entire project and rents it to the client, but with the latter's agreement to make payments into an account, which will eventually result in the lessee's purchase of the physical asset from the lessor. Leased assets must have productive usages, like buildings, aircrafts or cars, and rent should be pre-agreed to avoid speculation.



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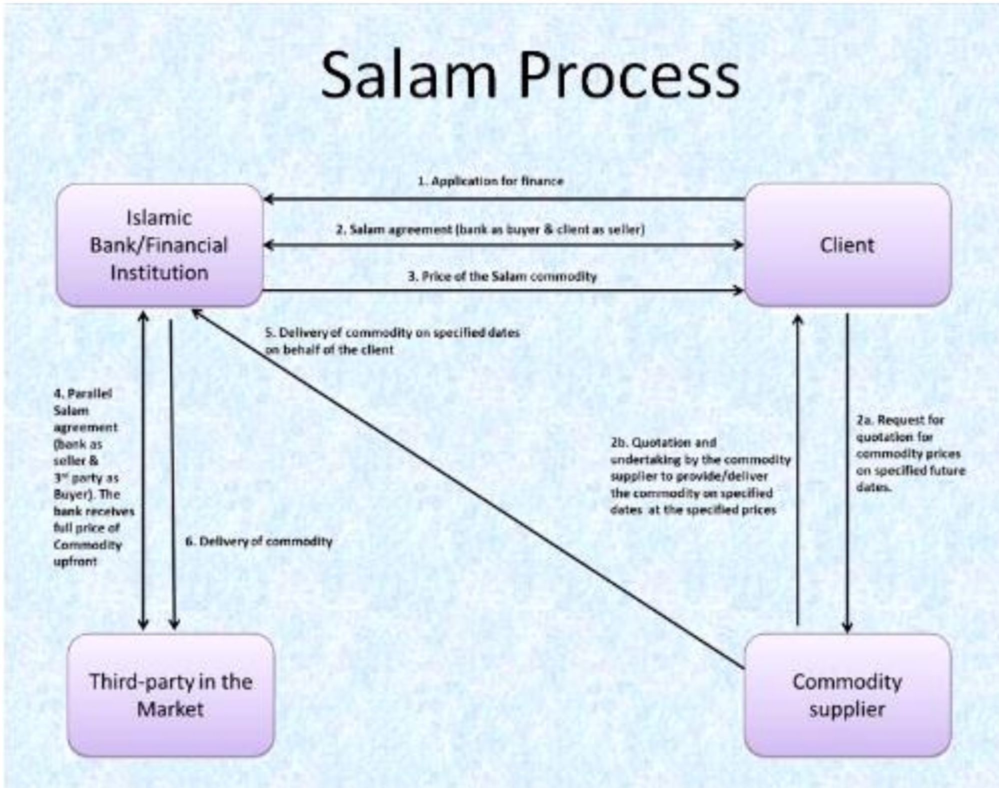
Salam (advance purchase)

Salamis purchase of specified goods for forward payment. This contract is regularly used for financing agricultural production.



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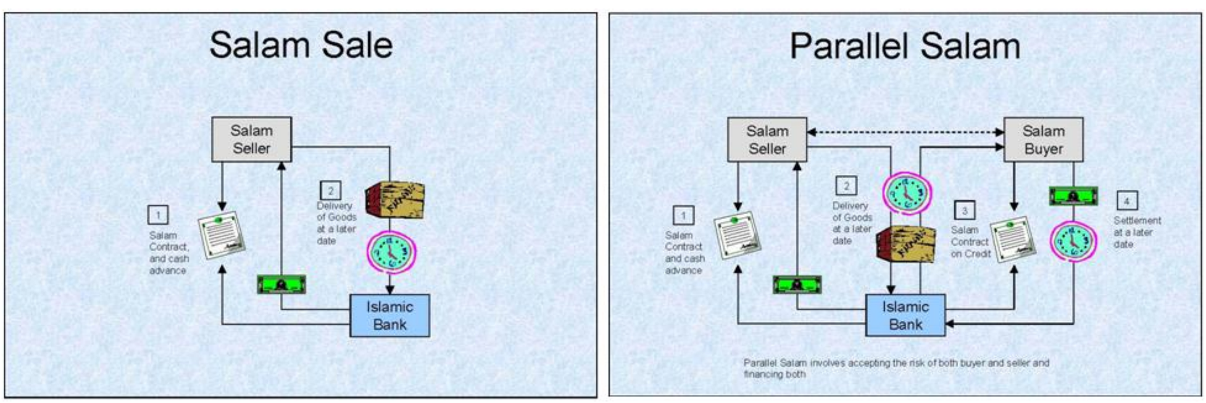

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Bai bi-thaminajil (deferred payment financing)

Bai bi-thaminajil involves a credit sale of goods on a deferred payment basis. At the request of its customer, the bank purchases an existing contract to buy certain goods on a deferred payment schedule, and then sells the goods back to the customer at an agreed price. The bank pays the original supplier upon delivery of the goods, while the bank's customer can repay in a lump sum or make instalment payments over an agreed period.

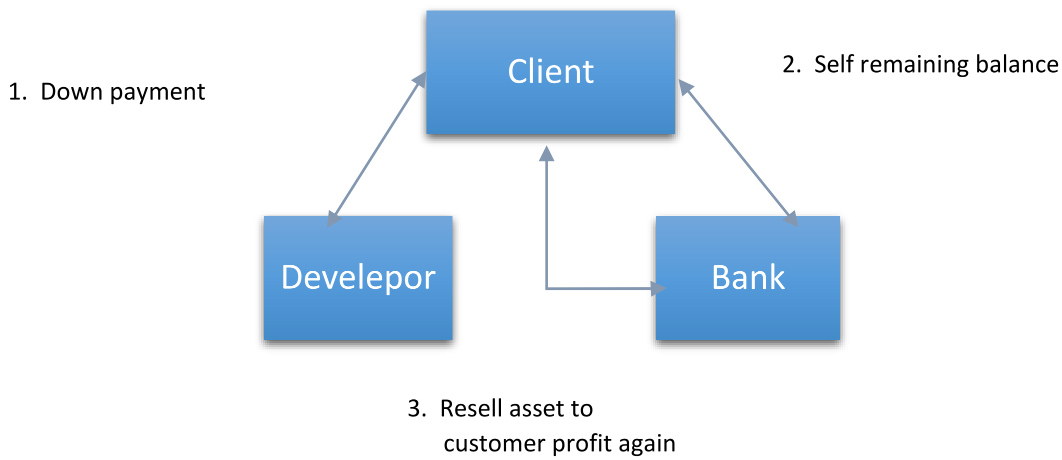


Fig: 1.11

Istisnaa (commissioned manufacture)

Although similar to *bai bi-thaminajil* transactions, *istisnaa* offers greater future structuring possibilities for trading and financing. One party buys the goods and the other party undertakes to manufacture them, according to agreed specifications. Islamic banks frequently use *istisnaa* to finance construction and manufacturing projects.

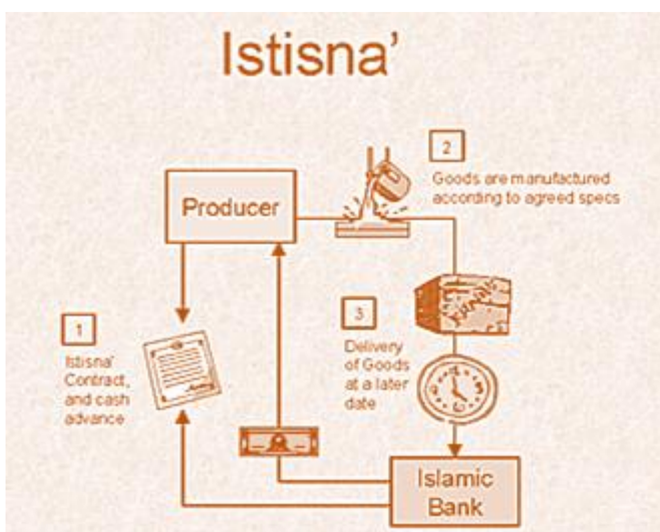
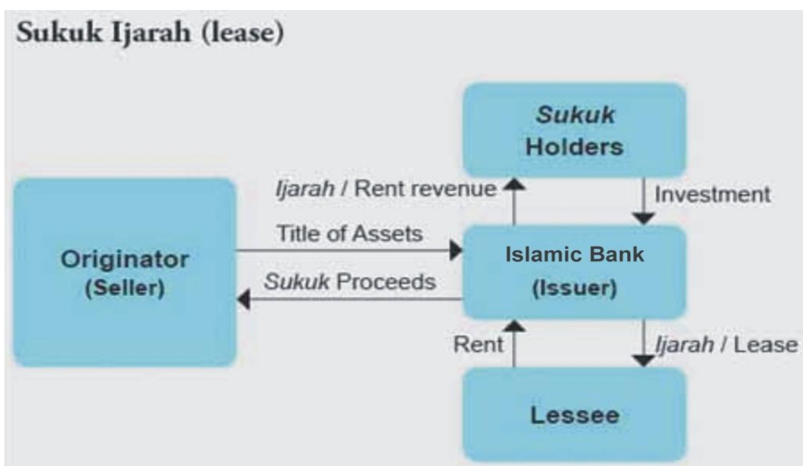


Fig: 1.12

Sukuk (participation securities)

Sukuk were introduced recently for the same reasons that led to the establishment of interest-free banking, which was to meet the requirements of those investors who wanted to invest their savings in *shari'a*-compliant financial instruments. As mentioned earlier, interest-based transactions and certain unlawful business activities (such as trading in alcoholic beverages) are ruled out in the Islamic mode of financing. However, this does not mean that the possibility of bond issuance is forbidden in Islamic finance as well. Recognizing that trading in bonds is an important element of the modern financial system, Muslim jurists and economists have focused on developing Islamic alternatives, and the *sukuk* have generated the most attention amongst these financial innovations.

The basic difference between conventional bonds and *sukuk* lies in the way they are structured and floated. In the conventional system of bond issue and trading, the interest rate is at the core of all transactions. In contrast, the Islamic *sukuk* are structured in such a way that the issue is based on the exchange of an approved asset (for example, the underlying assets could include buildings, hire cars, oil and gas pipelines and other infrastructure components) for a specified financial consideration. In other words, *sukuk* are based on an exchange of an underlying asset but with the provision that they are *shari'a*-compliant; that is, the financial transaction is based on the application of various Islamic commercial contracts. Thus, the equity-based nature of *mudaraba* and *musharaka sukuk* exposes investors to the risks connected with the performance of the project or venture for which the financing was raised. On the other hand, the issuance of *sukuk* on principles of *ijara* (leasing) and *murabaha* (cost plus sale) provides predictable and in some respects even a fixed return for the prospective investors. Under the *shari'a*, a financial instrument is eligible for trading in primary as well as secondary markets only if it assumes the role of *al-mal* or property. Insofar as a bond certificate is supported by an asset, and is transformed into an object of value, it qualifies to become an object of trade. The investor can sell the bond to the issuer or even to the third party if a secondary market for Islamic bonds exists. Therefore asset securitization is essential for Islamic bond issuance.



1. The *Sukuk* Holders feed the Islamic bank (Issuer of the *Sukuk*) with their investment.
2. The Originator sells the Asset to the Islamic bank in return the *Sukuk* Proceeds (investment).
3. The Islamic bank leases the Asset to the Lessee (can be the Originator – and cashes the rent, the Nett Amount of which is passed on to the *Sukuk* Holders (fixed income).
4. At maturity, the Asset is sold (often back to the Originator – who at start often promised to buy back at certain price at maturity or default of the Lessee) and the proceeds of that sale are distributed to the *Sukuk* Holders as repayment investment

Fig: 1.13

Financial Instruments Offered by Banks

If we discuss the financial instruments offered by banks, we deal with their funding, their sources of funds. Islamic banks of course have to follow the precepts of Islamic finance. This implies that not only their lending but also their funding should make use of halal financial instruments. Islamic banks are thus free to issue shares, but not conventional interest-bearing debt. In principle they offer instruments that pay a variable return, depending on the return on their assets.

Apart from share capital, Islamic banks attract funds by issuing or selling the following instruments:

- investment or PLS (profit-and-loss sharing) accounts
- savings accounts
- transaction accounts, or current accounts
- quardhasan accounts
- Borrowings.

Investment or PLS accounts

Investment or PLS accounts are in principle meant as mudaraba funds, with the depositor acting as rabbal-mal, or financier, and the bank as mudarib. If losses occur, these should be borne by the depositors. In practice, however, clients are not expected to share in any losses of the bank; in general there is a de facto guarantee on the capital sum of deposits. This of course is at variance with the principle that the mudarib, in this case the bank, should not shoulder any losses, but the forces of competition do not leave the banks with much choice. A common practice is the smoothing of profit disbursements over time through a profit equalization reserve into which a part of a bank's profits is paid. This enables the bank to avoid low profit disbursements to its depositors in lean years, or to increase profit disbursements in order to stay competitive if conventional banks increase interest rates on deposits (Wilson 2007).

Savings Accounts

Islamic banks can offer savings accounts guaranteeing the nominal value of the savings deposits and even providing a return. The guarantee can be given because of the legal fiction that the client's money is placed with the bank in custody, *amanah*, or safekeeping, *wadia* (Errico and Farahbaksh 1998; Sundararajan et al. 1998). Ideally, the money should be held by the bank in the form of cash and not be re-lent, but that does not seem to be the way the banks handle these accounts. The banks of course are not allowed to pay interest on these deposits, but anybody is free to bestow gifts on anybody else, and banks are no exception. They thus may pay depositors a gift, *hiba*, depending on their profitability. This is not a form of interest, or riba, because there is no promise of a predetermined payment. The Bahrain Islamic Bank, for example, offers savings account holders 'an annual rate of return based on what Allah has granted in the form of profits' (Raphaeli 2006).

Transaction Accounts or Current Accounts

Transaction or current accounts pay no interest, but the nominal value of deposits is officially guaranteed. Again, this is under the flag of amanah or wadia. In cases where conventional banks might pay interest, Islamic banks can offer free services. HSBC Amanah, for instance, offers depositors free payment services, provided their total deposits exceed some minimal value. In that case, clients also receive discounts on such things as the hire of a safe deposit box. Lloyds TSB assures its Muslim clients in the UK that the money they hold in their current account or in their so-called Islamic business account will be used by the bank in a sharia-compliant way. Overdrafts are not allowed, and if it proves impossible to intercept an electronic payment and a negative balance ensues, the bank will not demand interest but charge a fixed fee. On Lloyds TSB's Islamic student account overdrafts are allowed, but no interest is charged. Presumably a fixed fee does the trick.

Quard Hasan Accounts

Quard hasan accounts pay no interest and are meant to provide funds that the bank in its turn uses to grant quard hasan loans.

Borrowings

Conventional banks hardly ever do without fixed-income liabilities. The closest Islamic equivalents are surely sukuk and Islamic banks are starting to use these for their own funding. The pioneer was Malaysian Banking Berhad (Maybank), which issued a $300 million (RM 1.03 billion) subordinated Sukuk in 2006 in order to strengthen the bank.

Problems of PLS Funding

Profit-and-loss-sharing arrangements throw up problems in the relationship between a bank and its depositors. A bank's assets are not quoted on stock exchanges and its profits and losses are consequently difficult to ascertain. It is well-nigh impossible for depositors to assess the quality of a bank's outstanding loans. A predetermined rate of interest on deposits saves on information costs in such circumstances. For its part, it gives the bank, like its clients, a stronger incentive to try and allocate funds in the most profitable way. There is a moral-hazard problem.

PLS modes of finance may offer the banks an incentive for risk taking, and for operating with very little own funds. Depositors will have to take the brunt if investments go sour, just like equity investors in a conventional investment company, only they have no say in the appointment of the managers. It does not come as a surprise, then, that depositors appear to find PLS accounts less attractive than conventional time and savings deposits, and often prefer to hold their money in (guaranteed) transaction accounts if those conventional instruments are not available.

The Demand for Islamic Financial Products

Obviously, there is a demand for Islamic financial products; otherwise there would be no Islamic financial institutions, at least not in countries where people have a choice between Islamic and conventional banks. A picture of potential demand can be formed by looking at the results of surveys.

Islamic finance is spreading to regions where Muslims are a minority, including North America, Europe and South Africa. Even in the UK, with its Muslim population of roughly 1.8 million people, In 2007 the FSA mentioned an estimate of the size of the Islamic home finance market of ￡500 million out of a total stock of mortgage lending of over ￡1.1 trillion (Ainley et al. 2007, p. 22). In all fairness, it must be granted that the share is likely to grow.

Surveys on the demand for Islamic financial instruments do not always give the impression that the Muslim population can't wait a day longer for Islamic finance to become available. One thorough study is a survey conducted by Dr Humayon Dar, of Loughborough University, among over 500 Muslims. He found that only 5 per cent of UK Muslims were seriously interested in Islamic finance and that an additional 23 per cent would be interested in Islamic financial services such as mortgages if these were comparable in price with conventional interest-based mortgages (Dar 2004). Other initiatives were developed in Belgium. A Dutch company, Intermediate Marketing Services (IMS), opened a website in Belgium where those interested in Islamic financial products could sign up after paying €25. The site was said to be commissioned by Islamic banks from the Middle East that considered setting up shop in Belgium if at least 100 000 people would sign up (de Jong 2004).

In the final months of 2002 the Cercled'Etudeset de Recherche en EconomieIslamique CEREI of Brussels conducted a survey among Muslims in mosques and via the Internet, focusing on home finance. No more than some 700 out of the more than 4000 copies of the questionnaire distributed were returned and it was found that 65 per cent of Belgian Muslims rent their homes, against 30 per cent of the whole Belgian population. Asked why they rent and did not buy, 61 per cent gave riba as the reason. This would mean that at least 61 per cent out of 65 per cent, or close to 40 per cent, of the Muslim population would be seriously interested in Islamic forms of home finance. Of home owners, 35 per cent of the Muslim population, 66 per cent had taken out a conventional mortgage, but 77 per cent of those 66 per cent said they only had done so out of necessity. This means that an additional 77 per cent of 66 per cent of 35 per cent, that is, nearly 18 per cent of the Muslim population, would be interested. Some of those that did not take out a conventional mortgage would no doubt be interested as well, which would lead to the

conclusion that the potential market might be as large as 60 to 70 per cent of Belgian Muslims. However, with only 17.5 per cent of the questionnaires returned this would be a rash conclusion.
Most of the non-returners can probably be assumed to be indifferent, and the situation might after all not be that much different than found in Dr Dar's survey. In the Belgian survey 53 per cent of the respondents did not invest their savings because of a fear of becoming tainted by riba or getting involved in haram activities. This abhorrence of riba has been found in the Netherlands as well.
A survey by the Dutch Rabobank indicated that some 200 000 Dutch Muslim households might be interested in Islamic home finance products (Verhoef et al. 2008, p. 25). Given that the total Muslim population in the Netherlands is around 900 000, this would mean a majority. It is not clear; however, to what extent this survey was representative. It appears that any financial firm considering whether to enter this market outside the Muslim world, and in large parts of the Muslim world as well, does not only need a good marketing strategy, but time and patience as well. Knowledge of financial matters was generally found to be low in surveys, especially among migrants groups, and with rising educational levels among second- and third-generation immigrants this may improve over time, which may help foster interest in the Islamic financial sector.

Further Reading:

- ✓ *Introduction to Islamic Banking and Finance By Brian Kettell ,2011*
- ✓ *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk*