

# Islamic Financial Systems\*

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*Islamic finance is emerging as a rapidly growing part of the financial sector in the Islamic world. Islamic finance is not restricted to Islamic countries, but is spreading wherever there is a sizable Muslim community.*

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ACCORDING to some estimates, more than 100 financial institutions in over 45 countries practice some form of Islamic finance, and the industry has been growing at a rate of more than 15 percent annually for the past five years. The market's current annual turnover is estimated to be \$70 billion, compared with a mere \$5 billion in 1985, and is projected to hit the \$100 billion mark by the turn of the century.

The growth in Islamic finance initially coincided with the current account surpluses of oil exporting Islamic countries. But its continued growth in the face of eroding oil revenues reflects the influence of other factors, such as the desire for sociopolitical and economic systems based on Islamic principles and a stronger Islamic identity. In addition, the introduction of broad macroeconomic and structural reforms in financial systems, the liberalization of capital movements, privatization, and the global integration of financial markets have paved the way for the expansion of Islamic finance.

## **What is Islamic finance?**

Islamic finance was practiced predominantly in the Muslim world throughout the Middle Ages, fostering trade and business activities with the development of credit. In Spain and the Mediterranean and Baltic states, Islamic merchants became indispensable middlemen for trading activities. In fact, many concepts, techniques, and instruments of Islamic finance were later adopted by European financiers and businessmen.

In contrast, the term "Islamic financial system" is relatively new, appearing only in the mid-1980s. In fact, all the earlier references to commercial or mercantile activities conforming to Islamic principles were made under the umbrella of either "interest free" or "Islamic" banking. However, describing the Islamic financial system simply as "interest-free" does not provide a true picture of the system as a whole. Undoubtedly, prohibiting the receipt and payment of interest is the nucleus of the system, but it is supported by other principles of Islamic doctrine advocating risk sharing, individuals' rights and duties, property rights, and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking but covers capital formation, capital markets, and all types of financial intermediation.

Interpreting the system as "interest free" tends to create confusion. The philosophical foundation of an Islamic financial system goes beyond

the interaction of factors of production and economic behavior. Whereas the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work ethic, wealth distribution, social and economic justice, and the role of the state.

The Islamic financial system is founded on the absolute prohibition of the payment or receipt of any predetermined, guaranteed rate of return. This closes the door to the concept of interest and precludes the use of debt-based instruments. The system encourages risk-sharing, promotes entrepreneurship, discourages speculative behavior, and emphasizes the sanctity of contracts (Box 1).

An Islamic financial system can be expected to be stable owing to the elimination of debt-financing and enhanced allocation efficiency. A "two-windows" model for Islamic financial intermediaries has been suggested in which demand deposits are backed 100 percent by reserves, and investment deposits are accepted purely on an equity-sharing basis. Analytical models demonstrate that such a system will be stable since the term and structure of the liabilities and the assets are symmetrically matched through

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profit-sharing arrangements, no fixed interest cost accrues, and refinancing through debt is not possible. Allocation efficiency occurs because investment alternatives are strictly selected based on their productivity and the expected rate of return. Finally, entrepreneurship is encouraged as entrepreneurs compete to become the agents for the suppliers of financial capital who, in turn, will closely scrutinize projects and management teams.

### Box 1

#### Principles of an Islamic financial system

The basic framework for an Islamic financial system is a set of rules and laws, collectively referred to as *shariah*, governing economic, social, political, and cultural aspects of Islamic societies. *Shariah* originates from the rules dictated by the *Quran* and its practices, and explanations rendered (more commonly known as *Sunnah*) by the Prophet Muhammad. Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the *Quran* and *Sunnah*. The basic principles of an Islamic financial system can be summarized as follows:

**Prohibition of interest.** Prohibition of *riba*, a term literally meaning “an excess” and interpreted as “any unjustifiable increase of capital whether in loans or sales” is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usuary but also the charging of “interest” as widely practiced.

This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined *ex post*, symbolize successful entrepreneurship and creation of additional wealth whereas

interest, determined *ex ante*, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

**Risk sharing.** Because interest is prohibited, suppliers of funds become investors instead of creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits.

**Money as “potential” capital.** Money is treated as “potential” capital - that is, it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is “potential” capital.

**Prohibition of speculative behavior.** An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.

**Sanctity of contracts.** Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.

**Shariah approved activities.** Only those business activities that do not violate the rules of *shariah* qualify for investment. For example, any investment in businesses dealing with alcohol, gambling, and casinos would be prohibited.

#### Basic instruments

Islamic markets offer different instruments to satisfy providers and users of funds in a variety of ways: sales, trade financing, and investment (Box 2). Basic instruments include cost-plus financing (*murabaha*), profit-sharing (*mudaraba*), leasing (*ijara*), partnership (*musharaka*), and forward sale (*bay salam*). These instruments serve as the basic building blocks for developing a wide array of more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets.

#### Market trends

Banking is the most developed part of the Islamic financial system. The state constitutions of Iran and Pakistan, for example, require their banking systems to be fully compatible with

Islamic law. In Egypt, Indonesia, Malaysia, Sudan and the Gulf Cooperation Council (GCC) countries, Islamic banking exists alongside conventional banking. Islamic banking is currently practiced through two channels: “specialized” Islamic banks and “Islamic windows”. Specialized Islamic banks are commercial and investment banks, structured wholly on Islamic principles, and they deal only with Islamic instruments. Islamic windows are special facilities offered by conventional banks to provide services to Muslims who wish to engage in Islamic banking. Both Western banks and banks headquartered in Islamic countries provide Islamic windows.

## Box 2

**Islamic financial instruments**

Some of the more popular instruments in Islamic financial markets are *Trade with markup or cost-plus sale (murabaha)*. One of the most widely used instruments for short-term financing is based on the traditional notion of purchase finance. The investor undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated margin. Around 75 percent of Islamic financial transactions are cost-plus sales.

**Leasing (ijara).** Another popular instrument, accounting for about 10 percent of Islamic financial transactions, is leasing. Leasing is designed for financing vehicles, machinery, equipment, and aircraft. Different forms of leasing are permissible, including leases where a portion of the installment payment goes toward the final purchase (with the transfer of ownership to the lessee).

**Profit-sharing agreement (mudaraba).** This is identical to an investment fund in which managers handle a pool of funds. The agent-manager has relatively limited liability while having sufficient incentives to perform. The capital

is invested in broadly defined activities, and the terms of profit and risk sharing are customized for each investment. The maturity structure ranges from short to medium term and is more suitable for trade activities.

**Equity participation (musharaka).** This is analogous to a classical joint venture. Both entrepreneur and investor contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the operation in varying degrees and agree to share the returns (as well as the risks) in proportions agreed to in advance. Traditionally, this form of transaction has been used for financing fixed assets and working capital of medium- and long-term duration.

**Sales contracts.** Deferred-payment sale (*bay mu'ajjal*) and deferred-delivery sale (*bay'salam*) contracts, in addition to spot sales, are used for conducting credit sales. In a deferred-payment sale, delivery of the product is taken on the spot but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in installments, provided there is no extra charge for the delay. A deferred-delivery sale is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market.

Traditionally, specialized Islamic banks have been well positioned to attract deposits, from Muslims, but these institutions have generally lacked the technical ability to invest efficiently. This gap has been bridged by the services of Western banks that swiftly and efficiently deploy funds into Islamically acceptable channels. But this has often meant lower returns for Islamic investors owing to the second layer of intermediation. This trend is changing. Islamic banks are becoming resourceful and are going global, in part owing to their increased integration with international markets. At the same time, aware of the potential of Islamic markets, Western banks are reaching out to investors directly and eliminating the middleman - the Islamic banks or Islamic windows of banks in Muslim countries. For example, Citibank opened its first Islamic bank subsidiary in Bahrain in 1996.

Historically, Islamic financial markets have lacked liquidity-enhancing instruments, thus eliminating a large segment of

potential investors. However, more liquid instruments are emerging through securitization: Islamic funds, with a current market size of \$1 billion, represent the initial application of securitization (see table). There are three types of Islamic funds: equity, commodity, and leasing. Equity funds, the largest share of the Islamic funds market, are the same as conventional mutual funds but with an Islamic touch that requires a unique "filtration" process to select appropriate shares. The filtration process ensures that the mode, operation, and capital structure of each business the fund invests in are compatible with Islamic law, eliminating companies engaged in prohibited activities and those whose capital structure relies heavily on debt financing (to avoid dealing with interest). For this reason, companies with a negligible level of debt financing (10 percent or less) may be selected, provided that the debt does not remain a permanent feature of the capital structure. The future of Islamic equity funds is bright in part

because of a new wave of privatization under way in Muslim countries such as Egypt and Jordan, and in high-growth Islamic countries such as Indonesia and Malaysia, where the demand for Islamic financial products is growing rapidly. Commodity and leasing funds are other forms of Islamic funds. Commodity funds invest in base metals. Leasing funds pool auto equipment and aircraft leases and issue tradable certificates backed by the leases.

International and regional institutions are working with Islamic finance and are contemplating the introduction of derivative products and syndication to enhance project finance. The International Finance Corporation (IFC) has successfully executed several transactions in the Middle East and Pakistan that conform to Islamic principles. While the introduction of derivative products is being cautiously studied, it is suspected that these incorporate interest and may also support speculative activities. Simple derivatives, such as forward contracts, are

being examined because their basic elements are similar to those of the Islamic instrument of deferred sale. Project Finance, which puts emphasis

on equity participation, is another natural fit for Islamic finance. The successful experimentation with long-term project financing in the

construction industry in Malaysia is a positive development in this area

<b>Emerging Islamic funds</b>				
<b>Fund</b>	<b>Type</b>	<b>Year launched</b>	<b>Financial institution</b>	<b>Size (million dollars)</b>
IIBU Fund II Plc	Leasing	1994	United Bank of Kuwait	51.5
Faysal Saudi Real Estate Fund		1995	Faysal Islamic Bank of Bahrain	27.0
GCC Trading Fund		1996	Faysal Islamic Bank of Bahrain	10.0
Oasis International Equity Fund	Equity	1996	Robert Fleming & Co. (United Kingdom)	16.6
Faisal Finance Real Estate Income Fund II	Real estate	1996	Faisal Finance (Switzerland) S.A.	100.00
Unit Investment Fund (all tranches)	Income/mudaraba syndication	1996	Islamic Development Bank (Saudi Arabia)	500.00
Al Safwa International Equity Fund	Equity unit trust	1996	Al-Tawfeed Company for Investment Funds Ltd.	27.0
Ibn Khaldun International Equity Fund	Equity	1996	PFM Group (United Kingdom)	25.0
Adil Islamic Growth Fund	Equity	1996	Faisal Finance (Switzerland) S.A.	10.0
Source: <i>Islamic Banker</i> , 1995-96, various issues.				

### Issues and challenges

Islamic financial markets are operating far below their potential because Islamic banking by itself cannot take root in the absence of the other necessary components of an Islamic financial system. A number of limitations will have to be addressed before any long-term strategy can be formulated.

- A uniform regulatory and legal framework supportive of an Islamic financial system has not yet been developed. Existing banking regulations in Islamic countries are based on the Western banking model. Similarly, Islamic financial institutions face difficulties

operating in non-Islamic countries owing to the absence of a regulatory body that operates in accordance with Islamic principles. The development of a regulatory and supervisory framework that would address the issues specific to Islamic institutions would further enhance the integration of Islamic markets and international financial markets.

- There is no single, sizable, and organized financial center that can claim to be functioning in accordance with Islamic principles. Although stock markets in emerging Islamic countries such as Egypt,

Jordan, and Pakistan are active, they are not fully compatible with Islamic principles. The stock markets in Iran and Sudan may come closest to operating in compliance with Islamic principles. Moreover, the secondary market for Islamic products is extremely shallow and illiquid, and money markets are almost nonexistent. Since viable instruments are not currently available. The development of an interbank market is another challenge.

- The pace of innovation is slow. For years, the market has offered the same traditional instruments geared toward

short and medium-term maturities, but it has not yet come up with the necessary instruments to handle maturities at the extremes. There is a need for risk-management tools to equip clients with instruments to hedge against the high volatility in currency and commodities markets. In addition, the market lacks the necessary instruments to provide viable alternatives for public debt financing.

- An Islamic financial system needs sound accounting procedures and standards. Western accounting procedures are not adequate because of the different nature and treatment of financial instruments. Well-defined procedures and standards are crucial for information disclosure, building investors' confidence, and monitoring and surveillance. Proper standards will also help the integration of Islamic financial markets with international markets.

Islamic institutions have a shortage of trained personnel who can analyze and manage portfolios, and develop innovative products according to Islamic financial principles. Only a limited number of Islamic institutions can afford to train their staffs and deploy resources in product development.

- There is lack of uniformity in the religious principles applied in Islamic countries. In the absence of a universally accepted central religious authority, Islamic banks have formed their own religious

boards for guidance. Islamic banks have to consult their respective religious boards, or *shariah* advisors, to seek approval for each new instrument. Differences in interpretation of Islamic principles by different schools of thought may mean that identical financial instruments are rejected by one board but accepted by another. Thus, the same instrument may not be acceptable in all countries. This problem can be addressed by forming a uniform council representing different schools of thought to define cohesive rules and to expedite the process of introducing new products.

### **Future directions**

The further growth and development of the Islamic financial system will depend largely on the nature of innovations introduced in the market. The immediate need is to deploy human and financial resources to develop instruments to enhance liquidity; develop secondary, money, and interbank markets; perform asset/liability and risk management; and introduce public finance instruments. The Islamic financial system can also offer alternatives at the microfinance level.

Securitization is a step in the right direction but even this requires more sophistication. The scope of securitization - the process of unbundling and repackaging a financial asset to enhance its marketability, negotiability, and liquidity - in Islamic financial markets is very promising, because current market operations are restricted by the dearth of

liquidity-enhancing products; secondary markets lack depth and breadth; and, more important, instruments for asset/liability management are simply nonexistent. With the expansion of securitization, the customer base of Islamic financial systems will grow as institutional investors, who have access to broader maturity structures, are attracted to the market; the secondary market will develop; and asset/liability management will become a reality. Other strong candidates for securitization include real estate, leasing, and trade receivables because of the collateralized nature of their cash flows.

Microfinance is another candidate for the application of Islamic finance. Islamic finance promotes entrepreneurship and risk sharing, and its expansion to the poor could be an effective development tool. The social benefits are obvious, since the poor currently are often exploited by lenders charging usurious rates.

An Islamic financial system can play a vital role in the economic development of Islamic countries by mobilizing dormant savings that are being intentionally kept out of interest-based financial channels and by facilitating the development of capital markets. At the same time, the development of such systems would enable savers and borrowers to choose financial instruments compatible with their business needs, social values, and religious beliefs.