Islamic finance – a history

Islamic finance is growing exponentially, and accountants need to understand the principles underlying this previously niche market. Dr Natalie Schoon explains.

a little bit of history

The financial industry has historically played an important role in the economy of every society. Banks mobilise funds from investors and apply them to investments in trade and business. The history of banking is long and varied, with the financial system as we know it today directly descending from Florentine bankers of the 14th – 17th century. However, even before the invention of money, people used to deposit valuables such as grain, cattle and agricultural implements and, at a later stage, precious metals such as gold for safekeeping with religious temples.

Around the 5th century BC, the ancient Greeks started to include investments in their banking operations. Temples still offered safe-keeping, but other entities started to offer financial transactions including loans, deposits, exchange of currency and validation of coins. Financial services were typically offered against the payment of a flat fee or, for investments, against a share of the profit.

The views of philosophers and theologians on interest have always ranged from an absolute prohibition to the prohibition of usurious or excess interest only, with a bias towards the absolute prohibition of any form of interest. The first foreign exchange contract in 1156 AD was not just executed to facilitate the exchange of one currency for another at a forward date, but also because profits from time differences in a foreign exchange contract were not covered by canon laws against usury.

In a time when financial contracts were largely governed by Christian beliefs prohibiting interest on the basis that it would be a sin to pay back more or less than what was lent, this was a major advantage.

Islamic banking

During medieval times (1,000 – 1,500 AD), Middle Eastern tradesmen would engage in financial transactions on the basis of Sharia'a, which incidentally was guided by the same principles as their European counterparts at the time. The Arabs from the Ottoman Empire had strong trade relationships with the Spanish, and established financial systems without interest which worked on a profit- and loss-sharing basis. These instruments catered for the financing of trade and other enterprises.

As the Middle Eastern and Asian regions became important trading partners for European companies such as the Dutch East India Company, European banks started to establish branches in these countries, which typically were interest-based. With the increasingly important role Western countries started to play in the world economy, conventional financial institutions became more dominant. On a small scale, credit union and co-operative societies based on profit- and loss-sharing principles continued to exist, but their activities were very much focused in small geographical areas.

Although it was not until the mid 1980s that Islamic finance started to grow

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exponentially, the first financial company in recent history based on Sharia'a principles was the Mit Ghamr savings project in Egypt. Mit Ghamr was a co-operative organisation in which the depositors also had a right to take out small loans for productive purposes. In addition, the project attracted funds to invest in projects on a profit-sharing basis. In 1971 the project was incorporated in Nasser Social Bank. From a handful of banks in the late 1970s, including the Islamic Development Bank and Dubai Islamic Bank, the Islamic banking industry has grown significantly. Since the late 1990s the industry has been growing at a rate of 10 – 15% per year, and is expected to keep on growing at this rate for some years to come. The number of banks offering Islamic financial services is growing and is no longer limited to small niche banks, and large conventional banks are offering Islamic finance through their 'Islamic Windows'. However, the balance sheet size of fully Sharia'a-based banks on a consolidated basis is not even remotely close to that of any of the large conventional banks, which has an impact on the transaction size they can execute on an individual basis. Large conventional banks on the contrary have the advantage of a big balance sheet and structuring capabilities that are well beyond the current potential of Islamic banks. In addition, the proven track record of conventional banks provides a higher degree of certainty than a newly established Islamic bank. On the other hand, Islamic banks operate completely within the ethical framework of Sharia'a and offer skill and expertise in structuring Sharia'a-compliant instruments. Thus, the two types of players are complementary, and by working closely together can achieve high market penetration and work on reaching the full potential of the market.

principles and prohibitions

Like every other aspect of Muslim life, Islamic banking is governed by Sharia'a and its interpretation (Fiqh). Together, these provide the ethical framework outlining the essence of economic well-being and the development of individuals. This framework does not specifically apply to Islamic banks, but to life and business generally. Fairness, honesty, avoidance of hoarding and avoidance of tort are an integral part of Sharia'a law, but so are the prohibition of riba, gharar and maysir.

In brief, these prohibitions are defined as follows:

- **Riba** (or usury) is the predetermined interest collected by a lender, which the lender receives over and above the principal amount it has lent out.

- **Gharar** (or uncertainty) is defined as to knowingly expose oneself or one's property to jeopardy, or the sale of a probable item whose existence or characteristics are not certain. An example in the context of Islamic finance is advising a customer to buy shares in a company that is the subject of a takeover bid, on the grounds that the share price is likely to increase. Gharar does not apply to business risks such as investing in a company.
- **Maysir** (or speculation) is an event in which there is a possibility of total loss to one party. Maysir has elements of gharar, but not every gharar is maysir.

In the context of the Sharia'a framework, money is seen as nothing more than a means to facilitate trade (rather than a store of value). Consequently, in combination with the aforementioned prohibitions, it is not possible for Islamic banks to provide financing in a similar fashion to conventional banks. Instead, other structures are applied in which the bank often plays a much larger role in the financing structure and becomes a partner in the project to be financed – rather than just a provider of money.

As defined in the accounting, auditing and governance standards for Islamic financial institutions, Islamic banks are founded on the concept of profit-sharing and loss-bearing, which is consistent with the Islamic concept that 'profit is for those who bear risk'. Profits are distributed according to a ratio defined in the contract, and any losses are distributed equally depending on the share in the project a party holds. The bank or financier partners with the company or individual seeking financing; the bank therefore holds part of the title to the underlying assets as well, depending on its degree of ownership.

Islamic financial products

Islamic financial products work on the basis that the bank and the customer share the risk of investments on agreed terms. Profits are distributed based on negotiated terms; risk is distributed based on the share of the ownership. In addition, Islamic financial products typically have an underlying asset or enterprise that requires financing. The remainder of this article describes the most used instruments in Islamic finance.

partnership contracts

The Mudaraba and Musharaka contracts are partnership arrangements in which either one (Mudaraba) or more partners (Musharaka) provide capital and/or skill and expertise to a Sharia'a-compliant project or business. Any profit that is generated is distributed between the partners based on a ratio that is pre-agreed in the contract and reflects a return on capital, but also the effort put in to managing the project or business. However, losses are distributed between the partners on the basis of the ratio of the capital provided. This implies that in a Mudaraba where only one party provides the capital, the loss is 100% borne by the capital provider (Rab al Mal), unless the managing party has been negligent in which case he bears all the loss.

Mudaraba and Musharaka transactions are typically applied to private equity investments or to asset management-type instruments. In the latter, the skill of the bank is their ability to seek out investment opportunities and to mobilise funds. In retail finance Musharaka contracts are often applied to provide home purchase plans.

cost plus financing

Murabaha contracts are contracts for the deferred sale of goods at cost plus an agreed profit mark-up. Murabaha has a variety of applications and is often used as a financing arrangement, for instance for receivables and working capital financing. A special form of Murabaha is the Commodity Murabaha, in which the underlying asset is a physical commodity (often an LME base metal). Commodity Murabaha is mainly used for inter-bank liquidity management.

leasing

Ijara contracts in Islamic finance are largely comparable with conventional leasing contracts, in which the lessee pays periodical rental payments to the lessor in return for the use of an asset. Both operational lease (Ijara) and finance lease (Ijara wa Iqtina – or lease ending in ownership) are permissible.

investment certificate or bond

Sukuk is a bond-type instrument, but unlike a conventional bond, the Sukuk holder also owns a proportional part of the underlying asset. The Sukuk can be based on each of the above mentioned instruments, with the Sukuk al Ijara being most applied. The basic structure involves an SPV that acquires the asset or enterprise on behalf of the Sukuk holders.

in brief

This history of finance and Islamic finance is a lot longer than the last 35 years or so. It is based on an ethical framework that does not only appeal to Muslims. The underlying economic and business principles are attractive to Muslims and non-Muslims alike.

Although interest and gambling are not permitted, there is no law banning wealth creation - the capital is a factor of production and hence it is recognised that there is an associated cost. However, purely making money with money without any identifiable underlying investment (whether it be an asset or an enterprise) is frowned upon. Therefore the product structures in Islamic finance all have an underlying asset and are based on risk- and reward-sharing between all parties involved. The Islamic finance market is growing exponentially, and new players are continuously entering the market. Although it is not likely to replace conventional financing, it is certainly here to stay. ■

Dr Natalie Schoon
Natalie joined the Bank of London and the Middle East in April 2007 as Head of Product Management.

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