A Primer on
Islamic Banking and Finance

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Lecture Outline

1. Islamic Shariah: An Overview
2. The Sources of Divine Law
3. Fundamentals of Islamic banking and finance
4. Islamic Finance: Evolution of Institutional Framework
5. Players in the Islamic Financial Industry
6. Operational Models of Islamic Banks
7. The Support Industry for Islamic Banking Industry
8. Islamic Financial Products
9. Causes of Global Financial Crisis
10. Islamic Financial Solution
11. Current Islamic finance is Shariah-compliant but not shariah-based
Islamic Sharia’a: An overview

- Islam as a ‘complete code of life’ encompasses every aspect of human life. It provides directives as to how economic and financial activities should operate based on moral and just economic system. The source of Islamic morality stems from Sharia’a. The following diagram shows the position of banking and financial activities within the framework of Islamic Sharia'a.
The Sources of Islamic Law

- **Quran (Text of God):**
  - The Quran is the primary source for discerning the laws of God.
  - It is binding on the Fuqaha (jurists) to recourse to while giving verdict on an issue.
  - The evidence found in other sources is subject to the Quran.

- **Sunnah (Words or Acts or Tacit Approval of The Prophet):**
  - It means “what was transmitted from the Prophet (Messenger of God) of his words, acts, and (tacit) approvals.”

  **Words:** The words of the prophet (pbuh) are what he commanded to lay down a law. This is also referred to as hadith (plural ahadith) in a narrow sense of the words.

  **Example:** Entitlement to revenue depends on a corresponding responsibility for loss.
The Sources of Islamic Law

- **Acts** refers to such actions of the Prophet (SAW) which has a legal content.
  - Example: The method of praying or doing hajj.

- **Tacit Approval** Tacit Approval means silence of the Prophet (pbuh) regarding an action which occurred in his presence or which was in his knowledge. His silence in these cases are taken as an approval of the action.
The Sources of Islamic Law

- **Ijma’ (Consensus):**
  - Literally means ‘agreement on a matter’.
  - After the death of the Prophet (pbuh) if in any case the legal framework necessary to give on an issue could not directly found in the Quran and the Sunnah then the Fuqaha would come to an agreement to resolve the issue.

- **Qiyas (Analogy):**
  - Literally means measuring or estimating one thing in terms of another.
  - It means analysing the underlying rationale of a legal ruling found in the Quran and/or Sunnah and then giving judgement on other issues based on the common rationale, called ‘Illah’, of the previous relevant cases.
The Sources of Islamic Law

- **Qiyas (Analogy): Contd**
  - Example: The underlying reason of prohibiting Wine was intoxication. Jurists then extend the prohibition rules to ...

- **Ijtihad (Interpretation):**
  - It arises from the personal experiences of scholars in unique situations.
  - The interpretation is valid as long as it does not contradict the Sharia’a principles.
  - Example: certain jurists allow Islamic banks to charge a penalty fees to clients for late payment. This penalty charge is then spent in charity in the name of the client. In one way it encourages the clients to pay on time and at the same time the bank is not financially benefiting from it.
Fundamentals of Islamic Banking and Finance

Financial Principles

- Fiqh, the understanding of Sharia'a or Islamic law, has evolved clear ideas about wealth, its management, and the specific ways to manage it.

- Progressively, the range of modern financial and wealth management ideas has been addressed by bankers and financiers in the Islamic field.
THE SHARIA'A

- The moral rules that underpin modern Islamic finance. May be characterized as Islamic law, its applications are best deemed as moral guidance or strictures.

- Sharia'h compliance refers to the decision to apply Islamic principles to financial transactions, whether in global markets or in Islamic-based markets.

- The range of Sharia'h compliance is broad. Compliance is driven by national legislation like:
  - The Accounting and Auditing Organization for Islamic Financial Institutions (‘AAOIFI’) standards,
  - The Islamic Financial Services Board (IFSB)
  - Prudential and regulatory standards,
  - Internal Sharia'h boards or client directives.
The Islamic law (Shariah) prohibits taking or giving interest (Riba) which is the most essential feature of Islamic banking. The basic sources of Shariah principles are the ‘Quran’ and the ‘Sunnah’, which are followed by the consensus of the jurists and interpreters of Islamic law. Profit sharing and fee-based financing approaches have developed in compliance with Shariah laws. These special modes of financing have emerged in retail, private and commercial banking for debt and capital markets, insurance, asset management, structured and project financing, derivatives, etc. Shariah Prohibits:

- Riba, which is taking or giving of interest
- Masir, which is involvement in speculative and gambling transactions
- Gharar, which is uncertainty about the terms of contract or the subjectmatter, e.g. prohibits selling something which one does not own
- Investment in businesses dealing in alcohol, drugs, gambling, armaments, etc. which are considered unlawful or undesirable
According to Quran, human beings are God's stewards in the created world and Muslims need to adhere to the Quranic guidance governing property and wealth. Private properties are treated like a loan from God.

Muslims are allowed to embrace both free market and socialistic views of economic organization.
- Paying Zakat was made obligatory for Muslims.
- Paying and receipt of Riba are forbidden to Muslims.

The Quranic ban on Riba is absolute and without rationalization. The interest on loans is the same as the forbidden Riba.

Although some philosophers have justified the reasons for banning interest, but Muslim consumers who believe that interest and Riba are the same thing, find this to be a matter of eternal importance and will not be satisfied with clever ethnic or religious values-oriented marketing.
Fundamentals of Islamic Banking and Finance

- Traditional banking intermediation between savers and enterprises is based on a bank borrowing from depositors and lending to businesses. The yield is Riba.

- Muslims have uncovered many examples of enterprise investment, leasing and sales methods that provide credit. The following Quranic verse opens a wide range of options to the Muslim investor:
  
  “Allah has permitted trade and prohibited Riba.”

- Islam distinguishes between the time value of money as a measure of investment efficiency and the means of determining yield. Yields are either based upon profit and loss sharing in the enterprise or negotiated price for sale or lease transactions.

- Money is not seen as having an intrinsic value independent of the result of an investment or transaction.
Islamic Finance:

Evolution of Institutional Framework

- First Islamic Bank established in Egypt
- Dubai Islamic Bank established under special law pioneering Islamic Banking in the region
- Fiqh Council of the OIC declares Takaful as fully Islamic paving the way for Islamic Insurance to flourish
- Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) established. The Institute acts as a nodal body advising on standards to be followed by Islamic institutions worldwide
- IFSB introduces ‘Standards’ on Basel II compliance for Islamic institutions
- Islamic Development Bank (IDB) established to foster the economic development and social progress of member countries and Muslim communities. IDB participates in equity capital and grant loans for projects in member countries
- Malaysia passes comprehensive legislation on Islamic Finance
- Sudan launches Islamic Banking
- Sudan's banking system becomes 100% Islamic
- Islamic Financial Services Board (IFSB) established in Malaysia. The organization enhances stability of the industry by issuing standards
- Total Islamic assets aggregate to USD 300 billion, growing at the rate of 10-15% over past 10 years

- Islamic assetsexpected to grow at 15% and exceed USD 1 trillion by 2016

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Islamic Finance: Evolution of Institutional Framework

- The first modern experiment with Islamic banking was initiated by late Dr. Ahmad Elnaggar in 1963 in Mit Ghamr, Egypt.

- In 975, the Islamic Development Bank (IDB) was created with the mission to provide funds for development projects in the member countries, and to make it a multi-state central bank for Islamic banks.

- Between 1975 and 1990, the focus was on replicating traditional commercial banking functions in a Sharia'h compliant manner.

- By 1980, capital markets, consumer banking and wealth management areas were included.

- The two regions with the most dynamic growth have been the Gulf Co-operation Council (GCC) states and Malaysia.

- Islamic banking and financial principles are now applied in more than 70 countries, and more than 200 institutions consider themselves to be Sharia'h-compliant.
Islamic Finance: Evolution of Institutional Framework

- GCC
  - Bahrain was the first Gulf Co-operation Council country to develop a comprehensive approach to Islamic banking and finance and also the host to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a multi-state regulatory body.

- The Bahrain Monetary Agency (BMA), the central bank and sole regulator of the financial sector in Bahrain, established the necessary supervisory and regulatory framework and mandated AAOIFI’s standards for BMA-regulated institutions and its Islamic bond (Sukuk) issuance programs.

- Qatar, Saudi Arabia, the United Arab Emirates and Kuwait have all formally supported Islamic banking and investment.
Islamic Finance: Evolution of Institutional Framework

Malaysia

- In 1959, the Bank Negara Malaysia, the Malaysian central bank, was established and it regulates the Islamic banking sector.
- In 1969, the practice of Sharia'a-compliant investment started in Malaysia.
- In 1983, the Bank Islam Malaysia Berhad (BIMB) was established as part of a national strategy for a dual-banking system.
- Malaysia hosts the Islamic Financial Services Board (IFSB) which is the second multi-state regulatory body for the industry, governing issues relating to international banking standards, such as the Basel Accords.
- Today, Malaysia has a dual-banking system and is among the most developed, interest-free financing systems in the world.

Pakistan

- Since 1950s, Pakistan has sought repeatedly to encourage the Islamization of its economy.
- In 2004, the State Bank of Pakistan (SBP), the central bank, has structured a clear and strong dual-track system.
Islamic Finance: Evolution of Institutional Framework

The Federal Deposit Insurance Corporation (FDIC) and various state banking agencies have created a flexible framework to allow certain Islamic banking activities to take place onshore (notably in New York, Michigan and Illinois) and for comprehensive activities to take place offshore (for example, Citibank operates an Islamic subsidiary in Bahrain).

- The Federal Reserve Bank has initiated a study group to facilitate Islamic banking and its implementation in the US.

- The Securities and Exchange Commission (SEC) regulates a growing number of Islamic mutual funds aimed at domestic US investors.

- Since 2002, the US government sponsored mortgage securitization companies, the Freddie Mac and Fannie Mae, have supported the development of Islamic alternatives to traditional mortgages.
Islamic Finance: Evolution of Institutional Framework

In 2002, the UK financial services regulator, the Financial Services Authority (FSA), and the Bank of England began to encourage the development of Islamic banking in the UK. Since then, two Islamic banks have been granted licenses in the UK.

- It is expected that more institutions will seek to establish themselves as UK-based Islamic banks.
Players in the Islamic Finance Industry

BANKS

- Islamic banks are the first building blocks of the Islamic financial system. The main functions of a typical Islamic commercial bank include:

  - (a) Investment and investment management. Islamic banks invest funds that have been placed or deposited with them (i.e., their own capital funds and funds in their customers’ investment accounts) through investment mechanisms that are consistent with the Sharia'h.

  - (b) Generic banking services. Islamic banks also offer a variety of financial services similar to traditional banks, including current accounts, fund transfers, credit cards, consumer goods finance, home finance, and small- and medium-sized business facilities, through Sharia'h-compliant arrangements.

  - (c) Social services. Islamic banks often carry out social services through activities financed by the purification fund or the Zakat and charity funds. In addition, they are also responsible for the development of human resources.

- In addition to commercial banks, there are also investment banks, specialized fund companies, and multilateral and development banks within the Islamic financial system.
Players in the Islamic Finance Industry

Equity and Capital Markets

- Islamic markets for equity allow potential individual and institutional investors to own shares in companies that are deemed to be Sharia'h-compliant. The modern limited liability corporation and the buying and selling of its shares was accepted as permissible in Resolution No. 63/1/7, 7th Session of the Fiqh Academy, in Jeddah in May 1992.

- Islamic capital markets have expanded to open avenues for businesses to raise funds through no equity investment instruments, such as Islamic bonds or Sukuk. The investment instruments are designed to fulfill the Sharia'h requirement and have a pre-determined investment period. At the end of this period the fund-raising entities are required to redeem the instruments (and repay the investments).

- In recent years, the Islamic bond markets have taken off with a growing diversity among issuers and instruments. There is a great deal of exploration of new approaches to solving financial challenges by applying hedging and derivatives.
Players in the Islamic Finance Industry

Takaful

- Referred to as Islamic insurance. In a Takaful relationship, the participants jointly contribute to a pooled fund for the purposes of providing mutual indemnity and protection for any of the participants exposed to defined risk under the Takaful policy.

- Unlike conventional insurance, there is an adaptation of the traditionally understood insurer-and-insured relationship in Takaful, as all participants are insurers and insured at the same time.

- A Takaful company or operator is responsible for managing the Takaful fund.
Players in the Islamic Finance Industry

**Waqf**
- Waqf is a concept of charitable giving that is widespread among Muslims and has strong parallels to the Anglo-American concept of a charitable trust. Islamic institutions and financial markets are becoming increasingly sophisticated about the management of waqf properties and this is spawning capital market activities.

**Zakat**
- Zakat is a charitable tax paid by Muslims according to Quranic guidance. Zakat funds are typically given at the discretion of people who are required to give them. These payments are frequently made by Islamic financial institutions on behalf of their clients.
Operational Models of Islamic Banks

- The global development of Islamic financial institutions has taken various organizational forms and types according to the needs of the Islamic financial communities in each country.

- Some countries have adopted a dual-banking system, where conventional financial institutions operate alongside fully-fledged Islamic financial institutions. Example, Bangladesh and Malaysia.

- Other countries have introduced a totally Islamic financial system, where only Islamic financial institutions are allowed to operate. Example, Iran.

- A further group of countries has decided that Islamic financial activities can be carried out only by fully-fledged Islamic financial institutions which have to be established alongside the conventional ones not allowed to offer Islamic services (in the case of Kuwait and Lebanon).

- The evolution of the global Islamic banking and finance industry is being continually refined in each country.
Operational Models of Islamic Banks

The Windows Model

- This refers to the operating structure where a conventional bank simultaneously carries out Islamic financial activities. Under this structure, the bank assure clients of segregated accounting and operations for conventional and Islamic activities.

Branches

- Under this structure, the Islamic financial services are offered through dedicated service delivery channels. For example, a conventional bank sets up a number of branches that offer only Islamic financial services.

Subsidiaries

- This refers to the operating structure where a separate legal entity (a subsidiary), owned by a conventional bank or other financial institution (a parent), is set up specifically to undertake Islamic financial services activities.

Fully-fledged Banks

Fully-fledged Islamic banks are set up to participate solely with Islamic financial services, offered through their own service delivery channels.
Support Institutions for Islamic Banking Industry

- Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)
- The International Islamic Financial Market (IIFM)
- The International Islamic Rating Agency (IIRA)
- The Islamic Financial Services Board (IFSB)
- The Islamic Research and Training Institute (IRTI)
- The General Council for Islamic Banks and Financial Institutions (GCIBFI)
Support Institutions for Islamic Banking Industry

REGULATORS

- The regulators are tasked to ensure the integrity of the financial system and to help protect the interests of the stakeholders of financial institutions.

- The Islamic banking and finance industry is regulated by the central banks or monetary authority responsible for a country's entire banking and finance industry. Two strong self-regulatory bodies: AAOIFI and IFSB.

- AAOIFI has achieved this by developing high quality interaction with the International Accounting Standards Board (IASB).

- The IFSB has achieved this by integrating into the Basel framework and including entities like the International Monetary Fund in its membership.
Support Institutions for Islamic Banking Industry

Standard-setters

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

- AAOIFI is the autonomous entity responsible for the formulation and issuance of accounting, auditing, ethics, governance and Sharia'h standards for the international Islamic banking and finance industry.

- AAOIFI is a member of the IASB.

- The AAOIFI standards are setting best practice on how to handle financial reporting issues specific to Islamic institutions.
Support Institutions for Islamic Banking Industry

Standard-setters

The Islamic Financial Services Board (IFSB)

- The IFSB standards are mainly based on the identification, management and disclosure of risks relevant to Islamic products and operations.

- The IFSB coordinates closely with the Bank for International Settlements (BIS) and includes the Organization of the Islamic Conference (OIC) member state central banks, multi-lateral banking regulators and a diverse group of central banks from non-OIC countries, including the UK, China and Singapore.

- The OIC is an inter-governmental organization, grouping 57 states. These states combine their efforts to safeguard the interests of Muslims worldwide.

- Members of the IFSB are usually central banks hosting Islamic financial institutions which are invited to apply the IFSB standards (which are optional) in order to provide a favorable regulated environment for the Islamic financial services industry.
Support Institutions for Islamic Banking Industry

**Standard-setters**

The international Islamic banking and finance industry is also supported by several other institutions such as:

- The International Islamic Financial Market (IIFM), which strives towards the establishment, development and promotion of Islamic financial markets.

- The General Council for Islamic Banks and Financial Institutions (GCIBFI), whose mission is to promote Islamic financial institutions and disseminate rules and concepts related to Islamic finance.

- The International Islamic Rating Agency (IIRA), whose mission is to rate Islamic finance institutions.

- The Islamic Research and Training Institute (IRTI), whose mission is to promote Islamic research and training.
### Islamic Modes of Financing

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Financial *Murabahah*

- The financial institution buys and then sells the good to the client at a mark-up
- The bank must own and possess the good
- The profit rate and other terms should be clearly specified in the contract
- The bank can ask for guarantees or collateral
**Ijarah and Ijarah wa Iqtina**

- A leasing contract involving sale of usufructs of durable assets/goods
- Ownership of the asset is not transferred to the lessee
- The maintenance costs can be paid by the lessee if included in the contract, but costs of total damage of asset is borne by owner
- A hire-purchase leasing contract—ownership is transferred to lessee at the end of the contract period
- *Fiqhi* objections—two contracts in one; purchase contract cannot be binding
- Banks give away the asset at nominal value or as a gift at the end of the lease period
Salam

- A pre-production sale of goods—selling goods in advance
- Used to finance the agricultural sector
- The price has to be fixed and paid when the contract is concluded
- The delivery time should be fixed
- Parallel salam
Istisna

- A pre-production sale used when an item/asset needs to be manufactured/constructed
- The price of the good/asset should be known and time of payment (can be negotiated among the parties)
- The seller of the good/asset (bank) can either manufacture it or sub-contract it—parallel istisna
- The bank, however, liable for the delivery of good/asset
Mudarabah

- A form of partnership—one party supplies the capital (rab ul mal) other manages (mudarib)
- Profit shared among parties at an agreed upon ratio
- Financier cannot ask for a guarantee of capital or return
- Mudarabah can be restricted or unrestricted

A partnership contract in which all partners contribute capital and labor
- Like a mudarabah, but all partners manage the project
- Profit shared among partners at an agreed upon ratio
Global Financial Crisis

- Interesting Facts
- Chronology of Financial Crisis
- Causes of US Subprime Crisis
- Common View by Islamic Financial Scholars
- Implications for Global Economy
- Implications for Islamic Banking
- Islamic finance as an alternative
- Islamic theory of finance
- Current financial crisis would not have occurred in an Islamic financial system
Interesting Facts

- The Median house price increased 4 times during 1980-2007
- Stock Index increased from 803 in 1982 to 14,115 in 2007
- US Savings declined from 11% in 1980 to less than 1% in 2007
- Debt servicing increased to 35% in 2007
- An average American gained about 20 lbs in the last 20 years
- The US obesity was 15% in the 70s and it is 33% now
Interesting Fact

- In the 1980s, only two states (Nevada and New Jersey) had casinos, now 12 states has casinos and 48 states legalized betting
- In 1980, the US credit market debt was equal to US GDP
- In 2007, it had risen to 350 times of US GDP
- In 2007, CDS-45.5 trillion; US stock market 21.9 trillion; mortgage security market-7.1 trillion; US treasury market-4.4 trillion
- In contrast, the US GDP in 2007 was 13.4 trillion.
Chronology of Financial Crisis

- Financial institutions engaged in sub-prime lending coupled with adjustable interest rates
- The loans were packaged as Mortgage Backed Securities (MBS)/Collateralized Debt Obligations (CDO)
- Rating agencies gave positive rating to these securities
- Investment banks, hedge and pension funds, schools, municipalities and other investors put their money in these securities
Chronology of Financial Crisis

- Investors and speculators bought the CDS to hedge and speculate on the credit risks on the loans backing the MBS/CDO
- Investment banks and insurance companies, the primary issuers of CDS took on the risk of default of securitized assets in general and sub-prime loans in particular
Causes of the US Subprime Mortgage Crisis

Global Financial Crisis

- Interest-based finance
  - Excessive risk
  - Lack of proper regulations
  - Corruption
  - Speculations
  - Central bank policy
  - High demand for profit

- Securitization
- Lax on lending standards
- Sale of debt
- Credit Default Swaps (CDS)

Global Financial Crisis
Common view by Islamic financial scholars and practitioners

- Global financial crisis in reality is a crisis of failed morality
- Cause of greed, exploitation and corruption
- Failure in the relationship between investment originators and investors
- Failed to communicate potential risks involved in these transactions with the investors (borrowers)
Implications for global economy

- Sharp decline in global equity markets
- The failure or collapse of numerous global financial institutions
- Governments of a number of industrialised countries allocated in excess of $7 trillion bailout and liquidity injections to revive their economies
- Commodity and oil prices reached record highs followed by a slump
- Central banks reduced interest rates in coordinated efforts to increase liquidity and avoid recession and to restore some (confidence) in the financial markets.
Implications for Islamic banking

Islamic banking are examined on two fronts:

1) Direct impact of the crisis on the Islamic banking sector was minimal due in part to the intrinsic principles
   - Islamic banks were not caught by toxic assets as Shariah law prohibits interest
   - Lack of structured products and the reluctance of Islamic banks to exploit sophisticated financial instruments

2) Potential role that Islamic banking is suited to assume in order to deliver noteworthy contributions to the international financial system
   - Lending under Islamic law is based on the concept of asset backing, where real estate is being the preferred instrument to protect these investments.
Implications for Islamic banking

- Islamic financial sector also has suffered a sharp decrease in the value of *sukuk*
  - *Sukuk* = Islamic financial certificate, similar to a bond in Western finance complies with *Shariah*
- Standard & Poor’s believes long-term prospects are still strong
- Islamic banking and its ability to navigate to safe shores depend largely on the competence of the human capital integrating the ethos of Islamic teachings
- Chapra (2009) argues “The system is still in its infancy” “not fully prepared at present time to play a significant role” that’s why >>>
  - “Immaturity [of the Islamic financial industry] has, in part, saved [the industry] from a subprime-like mess so far”
Islamic finance as the alternative

- Advocates and the opponents of both schools of thought (government intervention and free market economies) thus far have failed to deliver a viable long-term solution to the crisis
- Nobel Prize Winner, French economist Maurice Allais believes that the way out of such crises is best achieved through structural reforms

- adjusting the rate of interest to 0%
- revising the tax rate to about 2%
- core elements of Islamic economics
Islamic finance

- Islam prohibits interest (riba)
- 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 socio-economic justice amongst Muslims
Islamic theory of finance and the global financial crisis

- **Shariah rules and regulations:**
  - *Islam establishes a unique system that protects individual investors and financial institutions from potential risks*
  - *Islamic finance is governed by Shariah rules*
  - **Forbid:**
    - *usury (riba)*
    - *gambling (maisir)*
    - *ambiguity (gharar)*
    - *stipulate that income must be an outcome of productive economic activities based on the principles of profit-and-loss-sharing contracts*
Islamic theory of finance

- Based on themes of Community Banking
- Ethical and Socially Responsible Investments
- Socio-economic justice
- Wealth accumulation and wealth distribution that is fair
- Supply of money therefore must be proportionate with the prospects of real growth
- Reinstate value for money and streamline its supply – currency peg
Islamic theory of finance

Financial approach of Muslims should be governed by major sets of rules:

- Muslims are strictly prohibited from investing in or dealing with economic activities that involve interest, uncertainty, and speculation.
- Muslims are, not only discouraged but also, forbidden from investing in businesses that are engaged in illicit (haram) activities.
- 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.
- Trade, not banking is the primary function of markets.

Islamic economics
Islamic theory of finance

- Absence of interest-based financial transactions under Islamic finance, financial relationships between financiers and borrowers are best understood within the framework of profit-and-loss sharing (PLS) contracts
  - both parties share the risk (and returns)
- Islamic finance advocate fairness in payoffs and reward structures and embrace socio-economic justice amongst all
- Principle of ‘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
Current financial crisis would not have occurred under an Islamic financial system

- If global banking practices adhere to the principles of Islamic finance, which are based on noble ideas of entrepreneurship and transparency, global crisis would have been prevented.

- Shariah principles:
  - *Not to sell a debt against a debt: one can’t sell or lease unless he/she posses real assets.*
  - *Islamic finance is based on equity rather than debt, and lending transactions are founded-on the concept of assets backing: mortgage loans under such system would have been backed by solid asset structure.*
Key Intrinsic Principles of the Islamic Financial System
Current financial crisis would not have occurred under an Islamic financial system

- **Shariah principles:**
  - *Islam takes particular interest in fostering close relationship and trust between originators (financial institutions) of Islamic financial products and investors.*
  - Absence of an adequate and effective regulatory control system that monitors and consequently ensures the interests of investors. Potential investors are well versed about the prospects (opportunities and risks) that their investments are subject to when entering into new contracts - Risk must be explicitly communicated!
  - *Honest implementation of Profit-and-Loss Sharing (PLS) transactions (such as Mudarabah and Musharakah contracts) in accordance with the spirit of Shariah entails full disclosure and transparency.*
  - *Islam regards the relationship between the lender (financial institution) and the borrower (investor) as a partnership.*
Current financial crisis would not have occurred under an Islamic financial system

Shariah principles continued:

- Risk sharing as apposed to risk taking is extended to include the prohibition of risk shifting as in CDS - risk shifting is gambling
- Islamic finance provides a moral and practical option for those keen to invest in socially responsible and/or in ethical investment portfolios
A Case Study: How Financial Murabaha evolved

- Murabaha: Islamic Classical Standard
- Murabaha: Modern Standard
- Murabaha: Islamic Banking Practice
- Risk Mitigation in Financial Murabaha
MURABAHA: Islamic Classical Standard

1. order
2. purchase
3. sell
4. pay

BANK

Client/customer

3rd party

deliver

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MURABAHA: Modern standard

1. order
2. purchase
3. sell
4. pay

BANK

Client/customer

3rd party
deliver
MURABAHA: Islamic Banking practice

1. Order

1a. authorize

4. sell

5. Pay installment

BANK

Client/customer

2. purchase

3. delivery

3rd party

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Financial Murabahah

- The financial institution buys and then sells the good to the client at a mark-up
- The bank must own and possess the good
- The profit rate and other terms should be clearly specified in the contract
- The bank can ask for guarantees or collateral
**Murabahah**-basic features

1. *Murabahah* is a sale contract
2. The seller reveals the actual price of the asset/good being sold and indicates the profit in lump-sum or as a percentage
3. Delivery of the asset/good is spot, payment can be spot or deferred
4. *Bai-muajjal* is a sale with spot delivery and deferred payment
Murabahah as Financing Mode

- As financial intermediaries, banks use *murabahah* as financing mode (Purchase order *murabahah* or financial *murabahah*)
- Financial *murabahah* is a combination of contracts
Financial *Murabahah*

Financial *murabahah* has the following elements:

1. Promise Agreement: The bank and the client signs and overall agreement of the promise to buy/sell
2. Agency Agreement: The bank appoints the client as an agent to purchase the good/asset
Financial *Murabahah (contd.*)

3. Purchase of the Good from the Supplier: The client buys the good and takes possession as an agent.

4. Offer of Purchase: The client offers to buy the good from the bank.

5. Acceptance of the Offer: The ownership of the good transferred from the bank to the client.

6. Debt created: Payment due at future date(s).
Points to note

- The commodity cannot be bought from the client
- If the bank purchases, the agency contract not needed
  - In such cases, two separate contracts (for supplier and buyer) and the purchase has to be before sale
- Bills of trade resulting from transaction can be transferred at face-value only
Risks in Financial *Murabahah*

- **Pre-Sale Risks**
  - Loss/damage of the good before delivery
  - Refusal of the buyer to take delivery
  - Market (price) risk

- **Post Sale Risks**
  - Latent defects in goods
  - Settlement (credit) risk
  - Market (benchmark) risk
Pre-Sale Risks Mitigation

1. Loss/Damage of good before delivery:
   - Before delivery, the good is bank’s responsibility
   - Risks mitigated by:
     - Minimize the period of holding (time between purchase and sale)
     - If time is long—insurance can be bought
Pre-Sale Risks Mitigation

2. Refusal of the Buyer to take Delivery: The bank is left with the good

- Risks minimized by:
  - The bank purchases the good with a right to return it within a specified time
  - The bank sells the good and client pays the difference between cost and sale price
“If, for any reason whatsoever, the agent shall refuse or fail to take delivery of the Equipment or any part thereof or shall refuse or fail to conclude the Sale Agreement, the Bank shall have the right to take delivery, or cause delivery to be taken, of the Equipment and shall have the right to sell, or cause the sale of, the Equipment (but without obligation on its part to do so) in a manner determined by it at its sole discretion and shall have the right to take whatever steps it deems necessary to recover the difference between the price realized upon sale and the price paid by the Bank plus any other expenses incurred by it in relation to the Equipment.”
Pre-Sale Risks Mitigation

3. Market (price) risk: Risk of changes in price prior to delivery of good to client

- Risks mitigated by:
  - Minimizing the holding time by selling immediately after buying
Post-Sale Risks Mitigation

1. Latent Defects in Goods: It is possible that the good supplied by the supplier is defective.
   - Risks minimized by transferring the liability to the vendor/supplier (through warranty)
Example of Clause in the Agreements

“If a latent defect is discovered in the Equipment, the Vendor undertakes to assign to the Purchaser, the benefit of any guarantee, condition or warranty relating to the Equipment which may have been given to the Vendor by the Supplier and which has been examined and accepted by the Purchaser and all other warranties or guarantees as may be implied by law or recognized by custom in favour of the Vendor. In addition to the assignment to the Purchaser as herein indicated, the Vendor shall take such other action as the Purchaser shall reasonably request to enable the Purchaser to claim against the Supplier”
Post-Sale Risks Mitigation

2. Settlement (credit) Risk: The risk that the client will not pay his/her dues on time or default

   Risk minimized by:
   - The bank can ask for a guarantee (sign a guarantee agreement)
   - Ask for a security or collateral—can sell the collateral if debtor defaults
   - Impose penalty for delinquency problem
Example of Clause in the Agreements

"The client hereby undertakes that if he defaults in payment of any of his dues under this agreement, he shall pay to the charitable account/fund maintained by the bank a sum calculated on the basis of ---percent per annum for each day of default unless he establishes thorough evidence satisfactory to the bank that his non-payment at the due date was caused due to poverty or some other factors beyond his control"
3. Market (benchmark rate) risk: The risk that the returns of the bank will be affected if the benchmark rate changes

- Risks minimized by:
  - The contracts are usually of short-run duration
Case Study: Legal Stratagem of Tawarruq

- Islamic Banking is mimicking conventional banking
- From Inah to Tawarruq
- Degrees of Separation to veil Riba
- Bai al-inah
- Tawarruq
- Has ownership really changed?
- The Unintended results
- Imam Taymiyah on Sale/Riba
Would “Islamic” Banking take the Same Route?

- What is the current model of “Islamic” banking?
- Is RIBA still not present?
- “Islamic” banking products mimic conventional via legal startegems
- Selected judgments may provide the indication
From Inah to Tawarruq to Sukuk

- The idea of making an impermissible transaction permissible through degrees of separation is not new.
- In fact, it underlies many of the juristic stratagems (hiyal) for circumventing prohibitions.
- By adhering strictly to the letter but not the spirit of the law.
Degrees of Separation to Veil Riba

A

RM100 Cash

RIBA

RM105 (deferred payment)

B
Bai’ul Innah

RM100 Cash

sell brick for cash

resell brick on credit

RM105 (deferred payment)
Degrees of Separation to Veil Riba

Riba (HARAM)

A

RM100
Cash

B

RM105
(deferred payment)

Bai’ul Innah (SYARIAH COMPLIANT?)

A

RM100
Cash

B

RM105
(deferred payment)

sell brick for cash
resell brick on credit

June 18, 2009
Tawarruq

A

Resells metal on credit

105 Cash (deferred payment)

B

C
Metal Trader

RM100 Cash

RM100 cash

Sells metal spot

Resells metal spot

June 18, 2009
Issues

- What is the function of C?
  - No change of ownership of metal
  - Legal subterfuge?
  - Individually: syariah-compliant
  - Read together: syariah-compliant?
- Recent High Court 18th July 08 judgment: Bai Al-Inah transaction...contains...rib...not approved by the Religion of Islam
- Effect of 2 degrees of separation
  - circumvent riba
- Structure obeys the letter of the law but subverts the spirit
- Form over Substance, Compliance over Essence
It is easy to see how we can keep adding degrees of separation until eventually it would become impossible for any jurists, however strict, to prohibit the practice as merely a trick to subvert the substance of Islamic Law (avoidance of interest-bearing loans) while adhering to its medieval juristic forms.
The Danger

- An impending subversion of Islamic Law
- By approving and eventually codifying (through AAOIFI, IFSB, OIC Fiqh Academy, etc.) legal stratagems to replicate conventional financial practices, jurists, bankers & regulators will eventually drown the substance of Islamic Law, if not already!
The (Unintended?) Result

- An illegal act will be made legal eventually, through the act of codification!
- With advances in structured finance, can easily disguise riba in any contract, and it would be the ultimate of disingenuousness to say "but this is bay` (sale), and Allah has permitted bay` and forbidden riba"
Taimiyyah

Like other major scholars, Ibn Taimiyyah considers bay al-inah a legal device in order to overcome the prohibition of riba, and is not deemed to be an act of sale, as there is clear evidence that such act amounts, in effect, to a contract of loan.

The use of legal device is evidence that the niyyah factor is undermined or made secondary.
Ibn Taimiyyah divides sales into three groups according to the buyer’s intentions, namely:

that he purchases the goods in order to use or consume them such as food, drink and the like, in which case this is sale, which God has permitted

that he purchases the goods in order to trade with them; then this is trade, which God has permitted

that the reason for purchasing the goods is neither the first nor the second, then the reason must be dirhams (money) which he needs, and it was difficult for them to borrow, so he purchases the goods on credit (with an increased dirhams) in order to sell it and takes its price. This, then, is ‘inah which is Haram according to the most eminent of the jurists.
Under the existing system, the liquidity (which is debt-based money) is injected into the economy via banks.

This bank money (fiat money created out of nothing), comes into existence in the form of debt/credit (a debt, but credited to borrowers account) when someone borrows.

The credit has interest attached to it.
Bank support

Because of the crisis, FRB/UK Treasury/ECB strengthened the banks by pumping money (printing money) as capital to the banks in return for equity in the banks.

But even after these banks were/are being 'saved' by the government, they still refused to extend credit/liquidity into the system.

They effectively not addressing the credit/liquidity crunch.

If the economy can accept bank-created fiat money WITH interest, there should be no difficulty for:

(i) government just to by-pass the banks and provide liquidity directly into the economy WITHOUT interest, i.e. debt-free money, or better still

(ii) instead of money coming into existence when someone borrows from the banks, the government (Treasury or Central banks) alternatively cause money to come into existence by spending into the economy.