1 Introduction to Islamic finance

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Essential features of Islamic finance

Islamic finance, as DeLorenzo explains in Chapter 2, is the provision of financial services on a basis that is compliant with the principles and rules of Islamic commercial jurisprudence (*fiqh al mu'amalat*), a branch of Islamic *Shari'a* jurisprudence. The focus of *fiqh al mu'amalat* is on contracts, and it lays down what types of contract are permissible or valid and what types are impermissible or invalid. In particular, contracts are impermissible if they involve *riba* (interest), *gharar* (uncertainty or ambiguity as to subject-matter, terms or conditions) or *maysir* (gambling or speculation). Interest is banned because a *pure return* or *rent on money* is considered to be immoral. To be entitled to a return, a provider of finance must either undertake business risk or provide some other service such as supplying an asset, otherwise the financier is, from a *Shari'a* point of view, not just an economic parasite but a sinner. Speculation and other forms of gambling are also considered as immoral. Uncertainty and the disputes to which it tends to lead are well-known issues in contract law; the rules of *fiqh al mu'amalat* endeavour to reduce it to a minimum, so as to mitigate problems arising from asymmetric information and disputes over the interpretation of contracts.

Islamic financial instruments, therefore, take the form of contracts. A number of such instruments have existed for hundreds of years, without the existence of Islamic financial institutions (IFIs). Because Islamic finance is based on contracts between providers and users of funds (or of financed assets), it was able to take place without the need for financial intermediaries. In fact, the development of IFIs did not begin until the second half of the 20th century. The reasons for this are examined in the next section.

The development of Islamic financial institutions

In western and central Europe, modern financial institutions (in both banking and insurance) started to evolve during the 17th century, notably in Britain, spurred by the development of mathematical

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techniques in finance and risk management. The industrial revolution in the late 18th and early 1
centuries provided the basis for their further growth. But in the Ottoman Empire (as in Russia), no su
developments took place. With the dissolution of the Ottoman Empire in 1918, Britain and Fran
established protectorates in a number of Arab countries that had been part of it, and western-sty
financial institutions were introduced, as they had been in other Muslim countries within the Britis
French or Dutch empires. In the absence of IFIs, those in need of financial services in those countri
turned to the western-style or conventional banks and insurance companies, without giving too mu
attention to their non-compliance with *Shari'a* rules and principles. In the case of savings, an alternati
was simply to hold them in the form of cash.

As Iqbal and Mirakhor explain in Chapter 4, this situation started to change in the 1950s and 196
after these countries achieved political independence. In the 1970s, the increased wealth of the Midd
Eastern countries, due to their oil production, gave rise to a major need for financial intermediation f
investment of the petro-dollars, mainly outside the Middle East and Islamic countries (which had
limited capacity to absorb such a volume of investment), and handled by conventional financ
institutions. This situation constituted a major impetus to the development of Islamic banki
institutions. Another major impetus came from the growing sense of Islamic identity and religio
consciousness in these now independent countries. Thus, while the first IFIs can be traced back to t
late 1950s, the main development of such institutions did not start until the mid 1970s. The growth
Islamic finance continued in the following decades and, as Wilson explains in Chapter 3, there are no
more than 300 IFIs worldwide managing assets in excess of US$200 billion.

The development of Islamic insurance companies has lagged behind that of Islamic banks. There a
two main reasons for this. First, the buying and selling of insurance conflicts with *Shari'a* prohibitions
maysir and *gharar*. In particular, the selling of insurance has characteristics in common with gambling,
that the insurer "wins" if the insured makes no claim and "loses" if a claim has to be paid. Moreover, t
situation of the two parties is uncertain, in that it depends on the occurrence of an event covered by t
insured risk.

The avoidance of these prohibitions required a highly sophisticated structure, which combin
mutual insurance with the characterisation of premiums as donations. In this structure, the element
gambling is avoided as the insurers and the insured are the same individuals; in the event of no cla
being made no individual insurer "wins", and if a claim is made no individual insurer "loses". T
characterisation of premiums as donations underlines the fact that the transactions are mutual; there
no buying or selling of insurance. In these circumstances, the element of uncertainty is consider
permissible.

Second, insurance relies on the ability to diversify risks and thus offers positive returns to scale. T
trend among conventional insurance companies has been ever-increasing size through mergers a
acquisitions. It has been harder for Islamic insurance to achieve these scale economies, because of t
smaller markets in which they operate.

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Corporate governance, regulatory, legal and accounting issues

The role of intermediary taken by Islamic banks raises issues of corporate governance over and above those that arise in the case of conventional banks. The latter receive deposits on the basis of what is essentially a debt contract, under which the depositors' capital and returns are not at risk (subject to the bank's solvency). Islamic banks, by contrast, receive "deposits" on the basis of a profit-sharing *mudaraba* contract, under which both returns and capital bear risk similar to that borne by shareholders. However, the "depositors" (that is, holders of profit-sharing investment accounts) do not have any rights, as shareholders do, in the corporate governance of the bank. This raises a number of regulatory issues, as discussed by Michael Clode in Chapter 5. In addition, the organs of governance of Islamic banks include a *Shari'a* supervisory board (SSB), which is responsible for supervising the *Shari'a* compliance of the bank's products and practices, as described by Daud Bakar in Chapter 6. This chapter also points out the problems caused by diversity in the opinions of different SSBs, and the role that can be played by *Shari'a* standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

Islamic finance involves a specific set of legal issues within *fiqh al mu'amalat*, as discussed by Mahmoud Fadeel in Chapter 7. These are essentially issues of contract law, which concern the *Shari'a* permissibility and validity of different contractual forms that may be used in Islamic financial services transactions. In addition, Fadeel draws attention to issues of the enforceability of such contracts in secular courts, from an international perspective.

A whole new set of accounting and financial reporting issues is raised by Islamic banking, as discussed by Taha Eltayeb Ahmed in Chapter 8. From an accounting perspective, not merely do the Islamic banking transactions themselves differ in crucial respects from those of conventional banks, notably as regards the avoidance of interest. In addition, presenting the results of these transactions fairly in the Islamic bank's financial statements requires financial reporting methods that are not covered by International Accounting Standards or by national accounting standards designed for conventional (ie, secular) business organisations. This situation led to the creation in 1991 of the Financial Accounting Organization for Islamic Banks and Financial Institutions, later to become AAOIFI, which has issued a set of financial accounting standards for Islamic financial institutions, as well as other standards and guidelines.

Types of financial services offered by Islamic banks and investment funds

IFIs offer a wide spectrum of financial services that are *Shari'a* compliant. In Chapter 9, Stella Cox describes investment services provided to the retail savings and investment market, as well as the market for consumer credit. She also refers to the regulatory and prudential issues that are involved. Islamic project finance is discussed by Syed Tariq Husain in Chapter 10. Islamic equity investment, and the methods of screening and purification that have to be applied in order to achieve *Shari'a* compliance, are described by Mohamed Elgari in Chapter 11.

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A key issue is the origination of *Shari'a* compliant assets. In the case of equity investment, *Sha*
compliance is achieved first through screening out shares of companies which have activities that a
unacceptable from a *Shari'a* point of view, notably the production of alcoholic or non-*halal* meat produc
gambling and armaments, those which have a large proportion of debt in their capital structure, a
those whose asset structure includes large amounts of cash, interest-bearing securities and accou
receivable. Screening is complemented by purification, which involves removing from income a
donating to charity any earnings from non-permissible sources, such as interest and small amounts
incidental income from the sale of alcoholic beverages. In the case of securitisation, assets backed
any form of debt cannot be converted into tradable securities, so that origination for that purpo
requires non-financial assets such as the lessor's interest in Islamic leases (*ijarah*).

Liquidity and risk management in Islamic banks

Liquidity management has been a problem area in Islamic banks, owing to the lack of *Shari'a*-complia
liquid assets and lender of last resort facility with the central bank. This has obliged Islamic banks to ho
relatively large amounts of non-income-producing cash. However, they have devised various ways
originating short-term income producing assets such as three-month commodity *murabaha* (credit sa
contracts, as explained by Youssef Shaheed Maroun in Chapter 12. More recently, as he describes, thre
month commodity *salam* (pre-paid purchase) contracts have been introduced for the same purpose a
have been securitised, but like the *murabaha* contracts these securities must be held to maturi
However, tradable five-year *ijarah*-backed securities have recently been issued by the Bahrain Moneta
Authority, and these can be held by Islamic banks as liquid assets.

Risk management in Islamic banks also raises a number of specific issues, which are examined
Kenneth Baldwin in Chapter 13. A major issue is the *Shari'a* acceptability of certain financial instrumen
that are similar to those used for risk management by conventional banks, such as interest rate swa
and options.

Methods for IFIs to achieve greater liquidity and credit enhancement are discussed by Simon Arch
in Chapter 14. Islamic finance permits securitisation of non-financial assets, such as leased (*ijar*
assets, or of asset pools (within a *mudaraba* or *musharaka* structure) that consist of a majority by value
non-financial assets. This chapter describes how structured finance can provide solutions for IF
provides examples of *Shari'a*-compliant securitisations and illustrates some alternatives for structuri
securitisation notes

The future: innovation and growth

The future development of the Islamic financial services industry sector depends crucially on its abil
to innovate, in order both to offer a more complete and competitive range of products and servic
comparable in scope and pricing to that offered by conventional financial institutions, and to manage

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risks efficiently to be more competitive. A major factor in this development will be the ability of contemporary *Shari'a* scholars to cope with the need for innovation (like their illustrious forebears in the classical age of *Shari'a* jurisprudence) in the production of *Shari'a*-compliant financial instruments that meet present-day market needs.

One of the most important of these needs is for the harmonisation of *Shari'a* rulings through the acceptance of *Shari'a* standards, as issued currently by AAOIFI, as a basis for their judgements as to *Shari'a* compliance. This will allow the scholars to devote most of their time to promoting and monitoring the implementation of these standards, as opposed to a situation in which they produce individual and diverse solutions to *Shari'a* issues. It will also lead to products and services having recognisable, generic characteristics, avoiding the diversity which results in a lack of transparency and problems of competitiveness.

However, the work of *Shari'a* scholars needs to take place in a context of innovation based on research and development directed towards new products and solutions to problems of financing in a *Shari'a*-compliant context. Such innovation requires specialists competent in financial engineering. Among the needs to be met by such innovations are the systemic needs for more income-producing liquid assets and an acceptable substitute for the central bank's lender of last resort function.

Further major factors in this development will be the emergence of Islamic financial markets and institutions such as *takaful*-based insurance companies, and the origination of a sufficient volume of *Shari'a*-compliant assets in which such institutions can properly invest. This will require, among other things, financial specialists proficient in Islamic asset origination, as well as credit rating agencies that have the expertise to issue credit ratings for Islamic securitisations.

The need for more financial engineering and asset origination specialists has labour market implications, notably in terms of competence and compensation, that will have to be faced. Relevant research and educational programmes in universities have the capacity to help in raising awareness of problem areas that require attention and of how the problems could be mitigated.

Islamic financial and capital markets currently lack the information intermediaries, in terms of competent financial analysts and commentators, that play an important part in making such markets informationally efficient in developed economies. The stock markets in countries where IFIs operate do not exhibit informational efficiency, breadth or depth and therefore offer limited opportunities for firms in those countries, including IFIs, to raise equity capital in the form of public share issues. In part, these problems are due to a lack of volume which could be mitigated by the stock exchanges in certain Islamic countries merging, as their counterparts in Europe have been doing. In turn, this would be likely to stimulate the interest of financial analysts and commentators, thus contributing to informational efficiency.

Finally, as the passage of the Sarbanes-Oxley Act in the US Congress and other related developments have emphasised, there is a need for firms that are active in financial markets to have a high quality of corporate governance, which in turn depends on ethical standards being observed. In this context, the role of financial industry regulators needs to be considered. For IFIs, a new international regulatory body

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has been established on a consortial basis by the central banks of a number of countries in which II
operate. This body, the Islamic Financial Services Board (IFSB), will issue voluntary supervisory a
prudential standards for its members, on a similar basis to those issued by the Basel Committee of t
Bank of International Settlements for its member countries (the so-called G10). In addition, the IFSB w
issue voluntary standards for the regulation of Islamic financial services.

With the introduction of the IFSB, the Islamic financial services industry sector has another maj
body, in addition to AAOIFI, that will promote international standards of excellence in key aspects
their operations, such as corporate governance, risk management and financial reporting. Provided t
labour market challenges can be met so that the necessary expertise is on hand, these developmen
provide the ingredients for the success of the Islamic services industry sector in international as well
regional financial markets.

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