ICS

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# Islamic Banking and Finance Guides

Islamic banking is banking or banking activity that is consistent with the principles of sharia (Islamic law) and its practical application through the development of Islamic economics. As such, a more correct term for Islamic banking is sharia compliant finance. (1)

Sharia prohibits acceptance of specific interest or fees for loans of money (known as riba, or usury), whether the payment is fixed or floating. Investment in businesses that provide goods or services considered contrary to Islamic principles (e.g. pork or alcohol) is also haraam ("sinful and prohibited"). Although these prohibitions have been applied historically in varying degrees in Muslim countries/communities to prevent unIslamic practices, only in the late 20th century were a number of Islamic banks formed to apply these principles to private or semi-private commercial institutions within the Muslim community.(2) (3)

As of 2014, sharia compliant financial institutions represented approximately 1% of total world assets.(4) By 2009, there were over 300 banks and 250 mutual funds around the world complying with Islamic principles (5) and as of 2014 total assets of around $2 trillion were sharia-compliant.(6) According to Ernst & Young, although Islamic Banking still makes up only a fraction of the banking assets of Muslims,(7) it has been growing faster than banking assets as a whole, growing at an annual rate of 17.6% between 2009 and 2013, and is projected to grow by an average of 19.7% a year to 2018.[6]

## Introduction

While secular historians and Islamic modernists see Islamic Banking as a modern phenomenon or "invented tradition", revivalists like Mohammed Naveed insist it is "as old as the religion itself with its principles primarily derived from the Quran".(8) (9) An early market economy and an early form of mercantilism, sometimes called *Islamic capitalism*, was developed between the eighth and twelfth centuries. (10) The monetary economy of the period was based on the widely circulated currency the gold dinar, and it tied together regions that were previously economically independent.

**A number of economic concepts and techniques were applied in early Islamic banking**, including bills of exchange, partnership (***mufawada,*** including limited partnerships, or ***mudaraba***), and forms of capital (*al-mal*), capital accumulation (*nama al-mal*),(11) cheques, promissory notes, (12) (Muslim traders are known to have used the cheque or **ṣakk** system since the time of Harun al-Rashid (9th century) of the Abbasid Caliphate.(13)), trusts (***Waqf***),(14) transactional accounts, loaning, ledgers and assignments.(15) Organizational enterprises independent from the state also existed in the medieval Islamic world, while the agency institution was also introduced during that time.[16] (17) Many of these early capitalist concepts were adopted and further advanced in medieval Europe from the 13th century onwards.(11)

# Usury in Islam

The word "**RIBA**" (interest) literally means "excess or addition", and has been translated as interest, usury, excess, increase or addition. According to Shariah terminology, it implies any excess compensation without due consideration (consideration does not include time value of money).[18]

**According to Islamic economists Choudhury and Malik**[19] by the time of Caliph Umar, the prohibition of interest was a well-established working principle integrated into the Islamic economic system.

**This interpretation of usury has not been universally accepted or applied in the Islamic world**. A school of Islamic thought which emerged in the 19th century, led by Syed Ahmad Khan, argued for a differentiation between sinful "**usury**", which they saw as restricted to lending for consumption, and legitimate "interest", for lending for commercial investment [20]

## 20th century

Building housing the Islamic Banking & Finance Institute Malaysia (IBFIM) in downtown Kuala Lumpur.

In the 20th and 21st century there has been "a gradual evolution of the institutions of interest-free financial enterprises across the world"[22]

In the 20th century, Islamic scholars such as Naeem Siddiqi, Maulana Maududi, Muhammad Hamidullah, all recognised the need for commercial banks and their perceived "necessary evil," and proposed a banking system based on the concept of ***Mudarabha,*** defined as a relationship in which one party contributes capital and other expertise to earn profit which is shared at an agreed upon ratio, such as 50:50. The Investor is called ***Rab ul Maal*** and the other party is termed as ***Mudarib.*** Further works specifically devoted to the subject of interest-free banking were authored by Muhammad Uzair (1955), Abdullah al-Araby (1967), Nejatullah Siddiqi (1961, 1969), al-Najjar (1971) and Baqir al-Sadr (1961, 1974).

## Since 1970

The involvement of institutions, governments, and various conferences and studies on Islamic banking (Conference of the Finance Ministers of the Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, **The First International Conference on Islamic Economics in Mecca in 1976,** and the International Economic Conference in London in 1977) were instrumental in applying the application of theory to practice for the first interest-free banks

**The influx of "petro-dollars" and a "general re-Islamisation" following the Yom Kippur War and 1973 oil crisis gave great help to the development of the Islamic banking sector.[29] and since 1975 it has spread the globe.**

**In 1975, the Islamic Development Bank was set up with the mission to provide funding to projects in the member countries**. The first modern commercial Islamic bank, **Dubai Islamic Bank, was established in 1979.**

By 1995, 144 Islamic financial institutions had been established worldwide, including 33 government-run banks, 40 private banks, and 71 investment companies.[37]

**By 2008 Islamic banking was growing at a rate of 10–15% per year and with signs of consistent future growth.** Islamic banks have more than **300 institutions spread over 51 countries, including the United States through companies such as the Michigan-based University Bank**, as well as an additional 250 mutual funds that comply with Islamic principles. **It is estimated that over US $822 billion worldwide sharia-compliant assets are managed according to The Economist**.

**In 2009, the Vatican put forward the idea that** "the principles of Islamic finance may represent a possible cure for ailing markets. *The Catholic Church forbids usury but began to relax its ban on all interest in the 16th century.*'

It is important to note that Islamic banking co-exists within the wider economy and as such is not a safe haven bubble despite often being labelled as such. During the global financial crisis of 2008, initially the market was not affected as the 'toxic assets' built up on the balance sheets of US banks were not shari'a compliant hence Islamic banks were not impacted. However following the collapse of Lehman Brothers Islamic institutions were impacted from drops in valuation of real estate and private equity, two segments heavily invested by Islamic firms

The market for Islamic Sukuk bonds has become strong enough that as of 2015, several non-Muslim majority states have issued sukuk—UK, Hong Kong, and Luxemburg

# Principles

The term "**Islamic banking**" refers to a system of banking or banking activity that is consistent with Islamic law (**Shariah**) principles and guided by Islamic economics. The contemporary movement of Islamic finance is based on the belief that "all forms of interest are RIBA and hence prohibited" In addition, Islamic law prohibits investing in businesses that are considered unlawful, or haraam (such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography, which are contrary to Islamic values). Furthermore, the Shariah prohibits what is called "***Maysir***" and "***Gharar***". ***Maysir*** is involved in contracts where the ownership of a good depends on the occurrence of a predetermined, uncertain event in the future whereas ***Gharar*** describes speculative transactions. Both concepts involve excessive risk and are supposed to foster uncertainty and fraudulent behaviour. Therefore, the use of all conventional derivative instruments is impossible in Islamic banking. In the late 20th century, a number of Islamic banks were created to cater to this particular banking market.

# Types of Islamic Lending

***Murabahah*** may be called an Islamic mortgage transaction, instead of lending the buyer money to purchase the item, a bank might buy the item itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in installments. However, the bank's profit cannot be made explicit and therefore there are no additional penalties for late payment. In order to protect itself against default, the bank asks for strict collateral. The goods or land is registered to the name of the buyer from the start of the transaction. Another approach is ***EIjara wa EIqtina***, which is similar to real estate leasing. Islamic banks handle loans for vehicles in a similar way (selling the vehicle at a higher-than-market price to the debtor and then retaining ownership of the vehicle until the loan is paid).

***Mudaraba*** is venture capital funding of an entrepreneur who provides labor while financing is provided by the bank so that both profit and risk are shared. Such participatory arrangements between capital and labor reflect the Islamic view that the borrower must not bear all the risk/cost of a failure, resulting **in a balanced distribution of income and not allowing the lender to monopolize the economy.**

Islamic banking is restricted to Islamically acceptable transactions, which exclude those involving alcohol, pork, gambling, etc. The aim of this is to engage in only ethical investing, and moral purchasing.

**In theory**, Islamic banking is an example of full-reserve banking, with banks achieving a 100% reserve ratio. **However, in practice**, this is not the case, and no examples of 100 per cent reserve banking are known to exist.

# Islamic Laws on Trading

The Qur'an prohibits gambling (games of chance involving money). The hadith, in addition to prohibiting gambling (games of chance), also prohibits ***bayu al-gharar*** (trading in risk, where the Arabic word ***gharar*** is taken to mean **"risk"** or excessive uncertainty).

There are a number of hadith that forbid trading in ***gharar***, often giving specific examples of ***gharhar*** transactions (e.g., selling the birds in the sky or the fish in the water, the catch of the diver, an unborn calf in its mother's womb etc.). Jurists have sought many complete definitions of the term. They also came up with the concept of ***yasir*** (minor risk); a financial transaction with a minor risk is deemed to be halal (permissible) while trading in non-minor risk (***bayu al-ghasar***) is deemed to be haram.What ***gharar*** is, exactly, was never fully decided upon by the Muslim jurists. This was mainly due to the complication of having to decide what is and is not a minor risk.

# Industry

**Islamic financial institutions take different forms. They may be**

1. full-fledged Islamic financial institutions (for example Islami Bank Bangladesh Ltd, Meezan Bank in Pakistan)
2. **Islamic windows in conventional financial institutions (for example: Commercial Bank of Dubai in UAE, HSBC, American Express Bank, ANZ Grindlays, BNP-Paribas, Chase Manhattan, UBS, Kleinwort Benson, Commercial Bank of Saudi Arabia, Ahli United Bank Kuwait, Riyad Bank;**
3. Islamic subsidiaries of conventional financial institutions (Citibank subsidiary Citi Islamic Investment Bank (Bahrain), UBS subsidiary Noriba Bank.

# Size, Locations

% market share of Islamic banking industry by country, 2006, Saudi Arabia 19.54

Bahrain 18.97; Malaysia 16.30; Kuwait 14.46 ; UAE 14.39; Qatar 3.79; Egypt 2.83;

Iran 2.82; Switzerland 1.8; Jordan 1.73; Bangladesh 1.24; Indonesia 1.11;

Pakistan 0.35; UK 0.25; Palestine 0.09;Yemen 0.06 and Rest of the world 0.03

SOURCE: ISI Analytics (2007)(21) (22)

**As of 2010, Islamic financial institutions operate in 105 countries**. Statistics on Islamic banking differ, but according to Ibrahim Warde, of those countries, **five dominate Islamic banking:** **Iran** with $345 billion in Islamic assets; **Saudi Arabia** with $258 billion, **Malaysia** $142 billion, **Kuwait** with $118 billion and **UAE** with $112 billion.(23) (24) Another source (ISI Analytics, see table to right) lists Saudi Arabia as the dominate country as of 2006, with Bahrain #2, and Iran relatively insignificant.

# Financial Accounting Standards

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), has been publishing standards and norms for Islamic financial institutions since 1993. By 2010, it had issued "**25** accounting standards, **7** auditing standards, **6** governance standards, **41** *shari'ah* standards and **2** codes of ethics. **The standards issued by AAOIFI are mandatory for Islamic financial institutions in Bahrain, Sudan, Jordan and Saudi Arabia,** and recommended for other Muslim countries and Islamic financial institutions according to Muhammad Akram Khan. Established in Algiers in 1990, its original name was Financial Accounting Organization for Islamic Banks and Financial Institutions. It later moved its headquarters to Bahrain.

# Supporting Institutions

**The International Islamic Financial Market**—a standardization body for Islamic capital market products and operations—was founded in November 2001 through the cooperation of the governments and central banks of Brunei, Indonesia and Sudan. Its secretariat is located in Manama Bahrain. It is not a regulatory body and its recommendations are "not implemented by most Islamic banks".(25)

**The Islamic Interbank Money Market** was established by Bank Negara Malaysia on 3 January 1994, and has developed instruments to manage the liquidity needs of the Islamic financial institutions -- "funding and adjusting portfolios over the short term".(25)

**The Islamic Financial Services Board** was founded on 3 November 2002 at Kuala Lumpur by central banks of Bahrain, Iran, Kuwait, Malaysia, Pakistan, Saudi Arabia, Sudan along with the Islamic Development Bank, AAOIFI, and IMF.(25) **As at April 2015, the 188 members** of the IFSB comprise 61 regulatory and supervisory authorities, eight international inter-governmental organisations, and 119 market players (financial institutions, professional firms and industry associations) operating in 45 jurisdictions. Its objective is to standardize and harmonize the operation and supervision of Islamic financial institutions, st standards and capital adequacy, risk management and corporate governance in consultation with a wide array of stakeholders and after following a lengthy process. It complements the task of the Basel Committee on Banking Supervision.(25) As of 2015 it had published 17 standards and six guidance notes.(26)

**Islamic International Rating Agency** started operations in July 2005 in Bahrain. It is sponsored by 17 multilateral development institutions and leading banks and other rating agencies.(27) (28)

**The Dow Jones Islamic Market Index** (DJIMI) was established in 1996.(29) The Index has been approved by Fiqh Academy of the OIC.(30) It uses three levels of screening—eliminating businesses involved in activities not allowed by Islamic law (alcohol, pork, gambling, prostitution, pornography, etc.); eliminating companies whose total debts divided by their 12-month average market capitalization are 33% or more of their total sources of funds; eliminating companies that have `impure income or expenditure` (including of course, interest) of more than 5-10 per cent of their income or expenditure (eliminating businesses with any `impure income` would be too difficult).(28)

**In 2006, Citigroup launched the Dow Jones Citigroup Sukuk** Index. The sukuk making up the Index must be at least $250 million in size, have a maturity of at lest one year and a minimum rating of BBB-/Baaa (28) In 1998, the FTSE Global Islamic Index was launched. It has 15 Islamic indices for various regions. (28) In 2007, the MSCI Islamic Index series was launched, one of the "MSCI ‘Faith-Based’ Indexes". It is constructed from the conventional MSCI country indices and covers 69 developed, emerging and frontier markets, including regions such as the Gulf Cooperation Council and Arabian markets.(28)

# Organizations

The "most prominent" research and training institutions listed in alphabetical order, "exclusively devoted to Islamic economics and finance", according to Muhammad Akram Khan are: (31) (32)

1. Islamic Economic Institute, previously Islamic Economics Research Centre, and before that International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, (**Saudi Arabia**)
2. Islamic Research and Training Institute (IRTI), Islamic Development Bank (IDB) Jeddah, (**Saudi Arabia**)
3. School of Islamic Islamic Banking and Finance, previously International Institute of Islamic Economics, Islamabad, (**Pakistan**) (IIUI),
4. Institute of Islamic Banking and Insurance, **London (UK**)
5. International Centre for Education in Islamic Finance (INCEIF), **Malaysia**
6. Islamic Finance Training, Kuala Lumpur (**Malaysia)**
7. Ethica Institute of Islamic Finance, **Dubai, UAE**
8. Islamic Finance Academy, **Dubai, UAE**
9. Centre for Islamic banking and Finance Training, Kuala Lumpur **(Malaysia)**

Institute of Islamic Finance**, London (UK)**

**10.** Islamic Finance Advisory and Assurance Services, **Birmingham (UK)**
**11.** Islamic Finance Institute of **South Africa**
12. Centre for Islamic Finance of **Bahrain**, Institute of Banking and Finance (BIBF)
**13.** Centre for Banking and Financial Studies, **Qatar**

# Bai' al 'inah (sale and buy-back agreement)

Literally, "A loan in the form of a sale *"Bai' al inah*" is a financing arrangement where the financier buys an asset from the customer on spot basis, with the price paid by the financier constituting the "loan". Subsequently the asset is sold back to the customer with deferred payment made in installments, constituting paying back the loan. There are differences of opinion amongst the scholars on the permissibility **of Bai' al 'inah**, however this is practised in Malaysia and the like jurisdictions.

# Bai' bithaman ajil (deferred payment sale)

This concept refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties. Like Bai' al 'inah, this concept is also used under an Islamic financing facility. Interest payment can be avoided as the customer is paying the sale price which is not the same as interest charged on a loan. **The problem here is that this includes linking two transactions in one which is forbidden in Islam**. The common perception is that this is simply straightforward charging of interest disguised as a sale

# Bai' muajjal (credit sale)

Literally **bai' muajjal** means a credit sale. Technically, it is a financing technique adopted by Islamic banks that takes the form of murabahah muajjal. It is a contract in which the bank earns a profit margin on the purchase price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in installments. It has to expressly mention cost of the commodity and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price. **Bai' muajjal** is also called a deferred-payment sale

# Mudarabah

"Mudarabah" or Profit-and-loss sharing contract is a kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The capital investment should normally come from both partners. Both should have some skin in the game.
**The Mudarabah (Profit Sharing) is a contract, with one party providing 100 percent of the capital and the other party providing its specialized knowledge to invest the capital and manage the investment project.** Profits generated are shared between the parties according to a pre-agreed ratio. If there is a loss, the first partner "rabb-ul-mal" will lose his capital, and the other party "mudarib" will lose the time and effort invested in the project The profit is usually shared 50%-50% or 60%-40% for rabb-ul-mal.

# Murâbaḥah

This concept refers to the sale of good(s) (such as real estate, commodities, or a vehicle) where the purchase and selling price, other costs, and the profit margin are clearly stated at the time of the sale agreement. With the rise of Islamic banking since 1975, Murabahah has become **"the most prevalent**" Islamic financing mechanism. **Murabahah works as finance when the lender/buyer pays the bank/seller for the good(s) over a period of time, compensating the bank/seller for the time value of its money in the form of "profit" not interest**. With a fixed rate of profit determined by the profit margin for the purchase of a real asset, this is a fixed-income loan. The bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional profit on late payments); however, the asset remains as a mortgage with the bank until the default is settled. This type of transaction is similar to rent-to-own arrangements for furniture or appliances that are common in North American stores.

# Musawamah

If the exact cost of the item(s) sold to the lender/buyer cannot be or are not ascertained, a financial transaction cannot be done on the basis of Murabahah, it is called musawamah (bargaining). Musawamah is the negotiation of a selling price between two parties without reference by the seller to either costs or asking price. While the seller may or may not have full knowledge of the cost of the item being negotiated, they are under no obligation to reveal these costs as part of the negotiation process. This difference in obligation by the seller is the key distinction between Murabahah and Musawamah with all other rules as described in Murabahah remaining the same. **Musawamah is the most common type of trading negotiation seen in Islamic commerce.**

# Bai Salam

Bai salam means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and **cannot be gold, silver, or currencies based on these metals.** Barring this, Bai Salam covers almost everything that is capable of being definitely described as to quantity, quality, and workmanship. Covers almost everything that is capable of being definitely described as to quantity, quality, and workmanship.

## Basic features and conditions of Salam

1. The transaction is considered Salam if the buyer has paid the purchase price to the seller in full at the time of sale. This is necessary so that the buyer can show that they are not entering into debt with a second party in order to eliminate the debt with the first party, an act prohibited under Sharia. The idea of Salam is normally different from the other either in its quality or in its size or weight and their exact specification is not generally possible.

2.Salam cannot be effected on a particular commodity or on a product of a particular field or farm. For example, if the seller undertakes to supply the wheat of a particular field, or the fruit of a particular tree, the salam will not be valid, because there is a possibility that the crop of that particular field or the fruit of that tree is destroyed before delivery, and, given such possibility, the delivery remains uncertain. The same rule is applicable to every commodity the supply of which is not certain.

3.It is necessary that the quality of the commodity (intended to be purchased through salam) is fully specified leaving no ambiguity which may lead to a dispute. All the possible details in this respect must be expressly mentioned.

4.It is also necessary that the quantity of the commodity is agreed upon in unequivocal terms. If the commodity is quantified in weights according to the usage of its traders, its weight must be determined, and if it is quantified through measures, its exact measure should be known. What is normally weighed cannot be quantified in measures and vice versa.

5.The exact date and place of delivery must be specified in the contract.

6.Salam cannot be effected in respect of things which must be delivered at spot. For example, if gold is purchased in exchange of silver, it is necessary, according to Shari'ah, that the delivery of both be simultaneous. Here, salam cannot work. Similarly, if wheat is bartered for barley, the simultaneous delivery of both is necessary for the validity of sale. Therefore, the contract of salam in this case is not allowed.

7.**This is the most preferred financing structure and carries higher order Shariah compliance.**

# Hibah (gift)

This is a token given voluntarily by a debtor in return for a loan. Hibah usually arises when Islamic banks pay their customers a 'gift' on savings account balances, representing a portion of the profit made lending funds from savings account balances. Unlike interest and like dividends on shares of stock, **Hibah cannot be guaranteed. Additionally, it is not time bound.**

# Istisna

Istisna (Manufacturing Finance) is a process where payments are made in stages to facilitate the work of manufacturing / processing / construction. An installment of Istisna, for example, may enable a construction company to finance construction of sections of a building or help manufacturers pay for an order of raw materials. **Istisna helps use of limited funds to develop higher value goods/assets in different stages / contracts.**

# Ijarah

Ijarah means lease, rent or wage. Generally, the Ijarah concept refers to selling the benefit of use or service for a fixed price or wage. **Under this concept, the Bank makes available to the customer the use of service of assets / equipment such as plant, office automation, motor vehicle for a fixed period and price.**

# Ijarah thumma al bai' (hire purchase)

*Parties enter into contracts that come into effect serially, to form a complete lease/ buyback transaction*. The first contract is an Ijarah that outlines the terms for leasing or renting over a fixed period, and the second contract is a Bai that triggers a sale or purchase once the term of the Ijarah is complete. For example, in a car financing facility, a customer enters into the first contract and leases the car from the owner (bank) at an agreed amount over a specific period. When the lease period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed price. The bank generates a profit by determining in advance the cost of the item, its residual value at the end of the term and the time value or profit margin for the money being invested in purchasing the product to be leased for the intended term. The combining of these three figures becomes the basis for the contract between the Bank and the client for the initial lease contract. This type of transaction is similar to the *contractum trinius*, a legal maneuver used by European bankers and merchants during the Middle Ages to sidestep the Church's prohibition on interest bearing loans. In a *contractum*, two parties would enter into three concurrent and interrelated legal contracts, the net effect being the paying of a fee for the use of money for the term of the loan. **The use of concurrent interrelated contracts is also prohibited under Shariah Law.**

# Ijarah-wal-iqtina

A contract under which an Islamic bank provides equipment, building, or other assets to the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the ome an integral part of the lease contract to make it conditional. The rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profit over the period of lease.

# Musharakah (joint venture)

Musharakah is a relationship between two parties or more that contribute capital to a business and divide the net profit and loss pro rata. This is often used in investment projects, letters of credit, and the purchase or real estate or property. In the case of real estate or property, the bank assesses an imputed rent and will share it as agreed in advance. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions. This concept is distinct from fixed-income investing (i.e. issuance of loans)

# Qard hassan/ Qardul hassan (good loan /benevolent loan)

Qard hassan is a loan extended on a goodwill basis, with the debtor only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor. In the case that the debtor does not pay an extra amount to the creditor, this transaction is a true interest-free loan. **Some Muslims consider this to be the only type of loan that does not violate the prohibition on 'riba**, *for it alone is a loan that truly does not compensate the creditor for the time value of money.*

# Sukuk (Islamic bonds)

*Sukuk*, plural of Sakk, is the Arabic name for financial certificates that share some similarities with conventional bonds hence are also commonly referred to as Islamic Bonds. A major difference between conventional bonds and sukuk is the structure of sukuk removes interest based elements which is replaced by an asset based income structure using most typically Ijara or Wakala contracts. Similarities are found at the issuance stage where Sukuk issuancein terms of documentation and regulation such as Reg S /144A and Reg S resembles closely that of a bond.

According to data published by the Islamic Financial Services Board, (33) total outstanding sukuk as of end of **2014 was $294 Billion**, of which **$188 Billion was from Asia,** and $**95.5 Billion** from the countries of the **Gulf Cooperation Council**. (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates).

# Tawarruq

**(Literally "turns into silver**") A product where a client customer buys an asset at a marked up price that is easily saleable and quickly sell the asset to raise cash. For example a client might buy $1,000 worth of a commodity like iron from a bank, on condition he/she does not have to pay for it until 12 months later and then immediately sell the metal back to the bank for $900 to be paid immediately. (This would be the equivalent of borrowing $900 for a year at an interest rate of 11 per cent.) The product allows clients to raise money quickly and easily, in theory without breaking Muslim bans on interest. **although the technique is controversial with some.**

# Takaful (Islamic insurance)

Takaful is an alternative form of cover that a Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. **Insurance by combining the risks of many people enables each individual to enjoy the advantage provided by the law of large numbers.**

# Wadiah (safekeeping)

**In Wadiah, a bank is deemed as a keeper and trustee of funds**. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands it. **The depositor, at the bank's discretion, may be rewarded with Hibah as a form of appreciation for the use of funds by the bank.**

# Wakalah (power of attorney)

This occurs when a person appoints a representative to undertake transactions on his/her behalf, **similar to a power of attorney.**

# Islamic equity funds

**Islamic investment equity funds market is one of the fastest-growing sectors within the Islamic financial system**. Currently, there are approximately 100 Islamic equity funds worldwide. The total assets managed through these funds exceed US$5 billion and are growing by 12–15% per annum. With the continuous interest in the Islamic financial system, there are positive signs that more funds will be launched. Some Western majors have just joined the market or are thinking of launching similar Islamic equity products.

Despite these successes, this market has been under marketed, as emphasis is on products rather than on addressing the needs of investors. Over the last few years, quite a number of funds have closed down. Most of the funds tend to target high-net-worth individuals and corporate institutions, with minimum investments ranging from US$50,000 to as high as US$1 million. Target markets for Islamic funds vary, some cater for their local markets (e.g. Malaysia and Gulf-based investment funds). Others cater to the Gulf and broader Middle East region, focusing on foreign rather than local market.

# Islamic derivatives

Derivatives instruments (such as stock options) have only become common relatively recently. **Some Islamic banks do provide brokerage services for stock trading.**

With help of Bahrain-based International Islamic Financial Market and New York-based International Swaps and Derivatives Association, global standards for Islamic derivatives were set in 2010. One main objective in Islamic derivatives is to avoid *"excessive"* risk. The "Hedging Master Agreement" provides a structure under which institutions can trade derivatives such as profit-rate and currency swaps.

## Microfinance

**Microfinance is a concern for Muslims and shows great opportunity for growth for Islamic financial organizations**. An estimated 72 percent of people living in Muslim-majority countries do not use formal financial services, often either because they are not available, and/or because potential customer believe conventional lending products incompatible with Islamic law.

According to the Islamic Microfinance Network website (as of circa 2013), (34) (35) there are more than 300 Islamic microfinance institutions in 32 countries. (36) but a number of studies have found that outreach has far to go.

One report (by Humayon Dar and coauthors) (37) found that Islamic microfinance made up less than 1 per cent of the global microfinance outreach, "despite the fact that almost half of the clients of microfinance live in Muslim countries and the demand for Islamic microfinance is very strong."(35)

A 2008 study of 126 microfinance institutions in 14 Muslim countries[104] found Islamic microfinance had a total outreach of 380,000 (38) from estimated total population of 77 million -- only 0.5% "of total microfinance outreach". **The largest Islamic microcredit outreach was Bangladesh, with over 100,000 clients** and two active institutions, but this compared with nearly 8 million borrowers using conventional microfinance products (such as those of the Grameen Bank) leaving Islamic microfinance with only 1% of the Bangladesh microfinance market. (39). (The total outstanding loan portfolio for Islamic Microfinance institutions studied was about $198 million in 2006, with an average loan size of $54. (40)

(**Muhammad Yunus, the founder of the Grameen Bank and microfinance banking**, and other supporters of microfinance, **though not part of the Islamic Banking movement**, argue that the lack of collateral and lack of excessive interest in micro-lending **is consistent with the Islamic prohibition of usury (riba).**

# Assessment and controversy

## Studies

**One of the controversies with regard to Islamic finance is the connection between the percentage return on accounts in Islamic banks and in conventional banks -- specifically how closely the results match each other**. This is thought by Islamic banking skeptics to be a suspicious coincidence suggesting manipulation of returns, but an important way of satisfying Islamic banking customers worried about risk to their

deposits but who want to be Islamically correct. A 2014 study using "the most recent econometric techniques" of the long-term relationship between Conventional Banks' term-deposit rates (TDRs) and the TDR of "participation banks'" (i.e. Islamic Banks) in Turkey found three of four participation banks term-deposit rates "significantly cointegrated" with those of Conventional Banks, and "permanent causality" from Conventional to all Islamic Banks. (41)
**Another study found** "strong and consistent empirical evidence" that the development of Shariah-compliant Islamic banking in Muslim countries does not "crowd out" the conventional banking but leads to "higher banking sector development, as measured by the amount of private credit or bank deposits scaled to GDP."(42)

# Authenticity

In March 2009, Sheikh Muhammad Taqi Usmani of the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI), a Bahrain-based regulatory institution that sets standards for the global Islamic Banking industry, declared that 85% of Sukuk, or Islamic bonds, were "un-Islamic". Usmani has been called "the granddaddy of modern-day Islamic finance".(43) According to another veteran of Islamic economics, Muhammad Akram Khan, criticizes Islamic banking as professing to have "put its business on a basis other than interest" but in practice devising "a whole host of ruses and subterfuges to conceal interest." Mahmoud Amin El-Gamal, a professor of economics at Rice University (United States), has described modern Islamic finance as “Shari’a arbitrage” -- i.e. what is prohibited in conventional finance becomes permissible when deemed “Shari’a compliant” despite having similar, if not the same, economic substance.(44)

In a 2006 dissertation Suliman Hamdan Albalawi concluded that the Islamic banking movement has "become main-stream," and Islamic banks at least in Saudi Arabia and Egypt have "departed from using profit-loss-sharing (PLS) techniques as a core principle of Islamic banking".(45) Islamic economist Muhammad Akram Khan also complained Islamic banking has evolved toward convergence with conventional banking "imitating conventional banks in product development" rather than establishing "a different type of banking which was aligned to fairness, equitable income distribution, and ethical modes of investment."(46) According to Mohammad Najatuallah Siddiqui, "while theory aspired to prove Islamic finance was different from conventional one, practitioners were busy searching for ways to make it similar to it. ... Starting sometime during nineteen eighties, Shariah advisors focused mainly on designing Shariah-compliant substitutes for financial products with which market was familiar."(47)

# Risk

**Whether Islamic banking is more or less risky than conventional banking is disputed.**

Zeti Akhtar Aziz, the head of the central bank of Malaysia maintains that sharia-compliant banks are "inherently more stable" than conventional peers and Speculation is forbidden. But according to the Economist magazine, "Dubai's debt crisis in 2009 showed that *sukuk* [Islamic bonds] can help to inflate debt to unsustainable levels."(48) According to one author (Mahmoud A. El-Gamal), while Islamic banks often avoid use of the word "customer" or "depositor" in favor of the term ‘partner’,

In these institutions, investment-account holders neither have the protection of being creditors of the Islamic financial institution, nor do they have the protection of being equity holders with representation on those institutions’ boards of directors. This introduces a host of other well-documented risk factors for the institution. (49)

Islamic banks are also criticized by some for not applying the principle of Mudarabah in an acceptable manner. Where Mudarabah stresses the sharing of risk, critics point out that these banks are eager to take part in profit-sharing but they have little tolerance for risk. To some in the Muslim community, these banks may be conforming to the strict legal interpretations of Sharia but avoid recognizing the intent that made the law necessary in the first place.

For example, the Malaysian bank RHB offers Islamic banking products, including vehicle loans. The product disclosure sheet, however, explains that in the event that the borrower defaults on the loan, the vehicle may be repossessed and any the borrower will be "responsible to settle any shortfall after your motor vehicles is auctioned off." This is an obvious contradiction to claims of risk-sharing. But he have to bear in mind that there are some different contracts used in Islamic financing. The one used at the RHB in vehicle financing is AITAB which is not at the same level with Mudharabah contract in terms of risk-sharing.

Some Islamic banks charge for the time value of money, the common economic definition of interest (riba). These institutions are criticized in some quarters of the Muslim community for their lack of strict adherence to Sharia.

The concept of Ijarah is used by some Islamic Banks (the Islami Bank in Bangladesh, for example) to apply to the use of money instead of the more accepted application of supplying goods or services using money as a vehicle. A fixed fee is added to the amount of the loan that must be paid to the bank regardless if the loan generates a return on investment or not. The reasoning is that if the amount owed does not change over time, it is profit and not interest and therefore acceptable under Sharia.

According to the IMF, since Islamic banking forbids pure monetary speculation and stresses that deals should be based on real economic activity, it poses less risk than conventional banking to the stability of financial systems (50)

# Non-Muslims influence

**The majority of Islamic banking clients are found in the Gulf states and in developed countries**. The majority of financial institutions that offer Islamic banking services are majority owned by Non-Muslims. With Muslims working within these organizations being employed in the marketing of these services and having little input into the actual day-to-day management, the veracity of these institutions and their services are viewed with suspicion. One Malaysian Bank offering Islamic based investment funds was found to have the majority of these funds invested in the gaming industry; the managers administering these funds were non-Muslim. (51) These types of stories contribute to the general impression within the Muslim populace that Islamic banking is simply another means for banks to increase profits through growth of deposits and that only the rich derive benefits from implementation of Islamic Banking principles.

# Riba as interest being a "*settled issue*"

Islamic finance is based on the belief that "**all forms of interest are *riba* and hence prohibited**".(28) When a minority member (i.e. one of the non-Muslim MNA—Member of the National Assembly—representing their religious group, rather than an electoral district) of the National Assembly of Pakistan questioned this in 2004, members of leading Islamist political party in Pakistan, the Muttahida Majlis-e-Amal (MMA) party, staged a walkout from the Assembly, protest what they termed derogatory remarks on interest banking:

Taking part in the budget debate, M.P. Bhindara, a minority MNA ...referred to a decree by an Al-Azhar University's scholar that bank interest was not un-Islamic. He said without interest the country could not get foreign loans and could not achieve the desired progress. A pandemonium broke out in the house over his remarks as a number of MMA members...rose from their seats in protest and tried to respond to Mr Bhindara's observations. However, they were not allowed to speak on a point of order that led to their walkout.... Later, the opposition members were persuaded by a team of ministers...to return to the house...the government team accepted the right of the MMA to respond to the minority member's remarks.... Sahibzada Fazal Karim said the Council of Islamic ideology had decreed that interest in all its forms was *haram* in an Islamic society. **Hence, he said, no member had the right to negate this settled issue. (**51)

The decree notwithstanding, a minority of scholars (Muhammad Abduh, Rashid Rida, Mahmud Shaltut, Syed Ahmad Khan, Fazl al-Rahman, Muhammad Sayyid Tantawy and Yusuf al-Qaradawi) have questioned whether *riba* includes all interest payments. (52) Others (Muhammad Akran Khan) have questioned whether riba is a crime forbidden by sharia (Islamic law) and subject to punishment like murder and theft, or simply a sin to be preached against by human beings with the punishment left to God, since "neither the Prophet nor the first four caliphs nor any subsequent Islamic government ever enacted any law against riba.(53).

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