1.2

The Development of Islamic Finance in the UK

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Introduction

Most of the growth of Islamic finance in the UK has taken place over the last five years. But the existence of Shari'a-compliant transactions in London's financial markets dates back to the 1980s. Commodity *murabaha*[1] type transactions through the London Metal Exchange were used, in significant volumes, to give liquidity to Middle Eastern institutions and other investors that fostered the development of a wholesale market in the UK. This did not, however, cater for retail Muslim consumers, as the products developed at the time were aimed exclusively at wholesale and high-net-worth investors. These products were relatively uncomplicated in structure and fell outside the scope of the regulators.

Retail Islamic products first appeared in the UK in the 1990s, but only on a very limited scale. A few banks from the Middle East and South East Asia began to offer simple products, such as home finance. However, these compared unfavourably with their conventional equivalents in several respects, including their generally uncompetitive pricing. Most of these products did not fall within the regulatory framework, so consumers did not have the same protection as other consumers; for example, the availability of the Financial Ombudsman Service and the possibility of redress from the Financial Services Compensation Scheme. The growth of the retail market remained slow throughout the 1990s and early 2000s.

Much has changed since then; both on the wholesale and the retail side, the quality of products has improved, a wider range of products has become available, and more players have entered the market. Today, London is seen by many firms, including Islamic as well as non-Islamic, as an increasingly important global centre for Islamic finance.

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[1] *Murabaha* is an agreement of sale of goods at a pre-determined profit mark-up on the price. Commodity *murabaha* is a mechanism used to create a Shari'a-compliant form of short -term deposit/placement by way of transactions in commodities, usually metals.

Reasons for growth

There are, perhaps, six main reasons for this growth:

Global expansion of Islamic finance

The first experience of Islamic banking in modern times seems to have been in the Middle East in the 1960s. It is, therefore, a relatively young industry and nobody really knows its exact size today. But from a small base, the market size is now estimated to be worth about £250 billion globally. There are also around 300 financial institutions around the world offering Islamic products.

Not surprisingly, the growth of the industry in the Middle East and South East Asia has influenced the UK market. Initially, products created in the traditional markets were brought into the UK by some of the key industry players, but now products developed in London are being marketed in other countries, for example in the Middle East.

Markets and skills base

London is well placed to take advantage of these trends. It has a tradition going back to the 17th century, if not before, of being willing to innovate and respond flexibly to new ideas. London has deep and liquid markets and the exchanges are among the most frequently used venues for listing and trading financial instruments globally. The London Metal Exchange has already been mentioned.

The UK financial services industry has a proven record of developing and delivering new products and a large pool of legal, accounting and financial engineering skills on which to draw. Several of these firms have now established or expanded offices in other Islamic centres. English law is already the preferred legal jurisdiction for many Islamic finance transactions.

Islamic windows

Several major international institutions, such as Citibank, Deutsche Bank and HSBC, have had a presence in the Middle East and South East Asia for several years. As a result, they have developed considerable knowledge and experience of local markets, including Islamic ones. To accommodate the new and growing demand for Islamic products, they have established business lines known as “Islamic windows”, some of which are based in the UK and others in the Middle East and South East Asia. These windows have contributed significantly to the development of Islamic finance because

of the institutions' global experience in product development and their access to far greater resources than those available to local institutions in the Middle East and South East Asia.

Excess liquidity in the Middle East

The sharp rise in oil prices since 2003 has resulted in huge liquidity surpluses and a surge in demand for Islamic, as well as conventional, assets in the countries of the Gulf region. The capacity of the local financial markets has not, however, been able to develop at the same speed. As a result, demand for assets has considerably outpaced supply, and Middle Eastern investors have been looking, in large numbers, for suitable alternatives. This demand was quickly identified by Islamic and conventional institutions that now provide a channel through which assets within other markets are sold to these investors, often by way of Shari'a-compliant transactions. This has been particularly notable in the UK. A recent example is the acquisition of Aston Martin by two Kuwaiti financial institutions, using Shari'a-compliant financing.

Public policy and taxation

Since the early 2000s, the government, for reasons of wider public policy, has introduced a series of tax and legislative changes specifically designed to remove obstacles to the development of Islamic finance. The first significant change came in the Finance Act, 2003 which introduced relief to prevent multiple payment of stamp duty land tax on Islamic mortgages. The Finance Acts 2005 and 2006 contained further measures aimed at putting other Islamic products on the same tax footing as their conventional counterparts. Most recently, the Finance Act, 2007 clarified the tax framework further, in the case of *sukuk*. This is very much work in progress.

Single financial regulator

Another contributory factor is institutional. The establishment of the Financial Services Authority (FSA) in 1997, combined 11 different regulators into a single body under a single piece of legislation. This has done much to resolve several of complications and conflicting views stemming from the previous regulatory regime where functions were divided. In particular, the FSA is able to look across the system as a whole to assess Islamic financial institutions and products.

This chapter appeared as part of the FSA document "Islamic Finance in the UK: Regulations and Challenges" (http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf) published in November, 2007.

1.3

Islamic Alternatives to Conventional Finance

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Introduction

Islamic finance has been growing at a rapid pace over the last few years. This has been accompanied with an extension of product ranges that caters to the diverse needs of investors on both the liabilities and assets side of Islamic banks. Financial solutions range from profit-and-loss sharing mechanisms, consumer finance (including for durables, credit/debit cards and housing finance), trade finance, working capital finance and project finance. Moreover, this list is evolving quickly and is providing a large number of viable alternative Shari'a-compliant solutions to conventional finance.

The emergence of Islamic financial products, particularly in capital markets, has also promoted greater global financial integration. The bringing together of financial institutions and market players across continents to participate in this expansion of inter-regional investment flows has fostered financial links amongst the major regions. This will not only provide greater synergies and opportunities, but will also contribute towards facilitating international financial stability.

Islamic finance instruments

The main principles of Islamic finance include the following:

- Strict prohibition on paying or receiving interest;
- Risks in any transaction must be shared between the parties, so that the provider of capital and the entrepreneur share the business risk in return for a share in the profits;
- Speculative behaviour is prohibited. This means that extreme or excessive uncertainty (*gharar*) or risk is prohibited, and thus contractual obligations and disclosure of information are necessary;
- Money is seen as potential capital and can only take the form of actual

capital when it is used in a productive capacity, or combined with labour; and

- Every economic activity is permissible unless explicitly prohibited by Shari'a, which includes injunctions contained in, or derived from, the Quran and the *Sunnah* (sayings and practices of the Prophet Mohammed).

The main Islamic modes of financing are briefly discussed below.

Financing through participatory modes

Musharaka

The literal meaning of *musharaka* is "sharing". In Islamic jurisprudence, *musharaka* means a joint enterprise formed for conducting some business in which all partners share profits according to a specific ratio, while the loss is shared according to the ratio of their contribution. It is an ideal alternative for interest-based financing with far reaching effects on both production and distribution.

The key features of *musharaka* are as follows:

- The ratio of profit distribution may differ from the ratio of investment in the total capital, but the loss must be divided exactly in accordance with the ratio of capital invested by each of the partners;
- Capital that is invested by the partners can be unequal and should preferably be in the nature of currency. If it is in the shape of commodities, the market value would be determined with mutual consent to determine the share of each partner. It may also be in the form of equal units representing currency called "shares", and the intended partners may buy these shares disproportionately;
- It is not allowed to fix a return or lump sum amount for any of the partners, or any rate of profit tied up with any partner's investment; and
- The liability of the partners in *musharakah* is normally unlimited. Therefore, if the liabilities of the business exceed its assets and the business goes into liquidation, all the exceeding liabilities shall be borne *pro rata* by all the partners. However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the excess liabilities shall be borne by that partner alone who has incurred a debt.

Mudaraba

Mudaraba is a kind of partnership where one partner gives money to another for investment in a commercial enterprise. The investment comes from the partner that is called *rabb al-maal*, while the management and

work fall under the exclusive responsibility of the other called *mudarib*. The profits generated are shared in a predetermined ratio.

The key features of *mudaraba* are as follows:

- One party provides the necessary capital and the other provides the human capital that is needed for the economic activity to be undertaken;
- The amount of investment shall be precisely determined and free from all liabilities;
- The entrepreneur who runs the business can be a natural person, a group of persons or a legal entity/corporate body;
- The profit earned is to be divided in a strict proportion agreed at the time of contract. The financier/investor cannot have a predetermined return or a lump sum absolute amount out of the profit;
- The operational loss is to be suffered by the *rabb al-maal* only. For the *mudarib*, the loss is in terms of unrewarded labour or entrepreneurship;
- The liability of the *rabb al-maal* is limited to his/her investment, unless the *rabb al-maal* has permitted the *mudarib* to incur any additional debt; and
- Both the parties may agree that no party shall terminate the contract during a specified period, except in specified circumstances.

Mudaraba is used mainly by depositors who tender their money (as capital owners) to a bank to be invested by the bank, as *mudarib*, on the basis of profit sharing according to agreed ratios. For investment funds, *mudaraba* is a high-risk venture because Islamic banking institutions provide capital to the *mudarib* who undertakes the work and management, and in case of loss, the whole financial loss will have to be borne by the bank as *rabb al-maal*, provided the loss is not caused by the negligence of the *mudarib*. The contract of *mudaraba* is traditionally applied to commerce alone, but it provides the basis of the relationships between banks, depositors and the entrepreneurs, and according to the majority of contemporary scholars, it can be applied in all sectors of the economy such as trade, industry and agriculture.

Financing through debt creating modes

These modes belong to the "low-risk" category and normally create debt when applied by Islamic banks. However, once the debt is created, there can be no increase over the amount of credit or debt stipulated.

Murabaha

Murabaha is the most widely used Islamic financial contract. It is an agreed profit-margin sale with spot or deferred payment of the sale price. *Murabaha* means the sale of goods by one party to another under an arrangement,

whereby the seller is obliged to disclose to the buyer the cost of the goods sold on either spot basis or deferred payment basis, and a profit margin is included in the sale price. It is suitable for corporate, consumer, agriculture, microfinance and other sectors where the client needs finance to purchase goods. It enables the client to procure finished goods, raw material, machinery or equipment through Islamic banks from the local market or through import. Normally, it is used for short-term financing needs, as Islamic banking institutions are able to fix a price at the outset to finance the purchase of goods for onward sale to their clients.

Some important considerations in a *murabaha* are as follows:

- The commodities, which are the subject of the sale, must be existing, owned by the bank (as seller) and in the bank's physical or constructive possession. Therefore, it is necessary that the bank must have first assumed the risks of ownership before selling the commodities to the client;
- The execution of the sale contract requires an offer and acceptance, which includes certainty of price, the place of delivery and the date on which the price, if deferred, will be paid;
- The appointment of an agent, if any, and the purchase of goods by/for and on behalf of the bank and the ultimate sale of such goods to the client shall be transactions independent of each other, and shall be separately documented. The agent should first purchase the commodity on behalf of the bank (ie. the financier) and take its possession thereof. Subsequently, the client would purchase the commodity from the bank through an offer and acceptance arrangement;
- The commodity will remain at the risk of the bank during the period of purchase of the goods by the agent and its ultimate sale to the client (buyer) and until its possession by the client;
- Once the sale transaction is concluded between the bank and the client, the agreed selling price cannot be changed;
- It can be stipulated while entering into the agreement that in case of late payment or default by the client, the client will be liable to pay a penalty calculated at an agreed percentage rate per day or per annum that will go to a charity fund constituted by the bank;
- The buyer/client may be required to furnish security in the form of a pledge, lien, mortgage or any other form of encumbrance on realizable assets. However, the mortgagee or the charge-holder shall not derive any financial benefit from such security; and
- A *murabaha* contract cannot be rolled over because once sold by the bank, the goods become the property of the client, and hence cannot be resold. *Murabaha* receivables cannot be securitized for creating a negotiable instrument to be traded in a secondary market.

Musawama

Musawama is a general kind of sale in which the price of the commodity to be traded is stipulated between the seller and the buyer without any reference to the price paid or cost incurred by the former. Thus, it is different from *murabaha* in respect of its pricing formula. Unlike *murabaha*, the seller in *musawama* is not obliged to reveal the cost or purchase price. All other conditions relevant to *murabaha* are valid for *musawama* as well. *Musawama* can be an ideal mode where the seller is not in a position to ascertain the precise costs of commodities that are offered for sale.

Salam

Salam is a kind of sale whereby the seller undertakes to supply specific goods to a buyer at a future date, in consideration of a price fully paid in advance. It is an exceptional mode in Islamic contractual theory for a sale transaction, whereby the existence of a subject matter and its ownership or possession by the seller is not necessary at the time of sale. Some additional considerations in *salam* are as follows:

- The buyer should pay the price, in full, to the seller at the time of effecting the sale; otherwise it will be tantamount to a sale of debt against debt, which is expressly prohibited by the Shari'a rulings (any unpaid price represents a debt to the buyer and a debt to the seller for the value of such goods not paid for in advance);
- The debt liability of the seller cannot be adjusted against the price for *salam* sale, in part or in full.
- *Salam* can be affected in only those goods that are normally available in the market and whose quality and quantity can be specified exactly;
- It is necessary that the quality of the goods intended to be purchased is fully specified, leaving no ambiguity leading to dispute among the parties involved in the transaction;
- The exact date and place of delivery must be specified in the *salam* contract. The parties may fix any date for delivery with mutual consent; and
- In order to ensure that the seller shall deliver the goods on the agreed date, the bank can also ask the seller to furnish a security, which may be in the form of a guarantee or in the form of a mortgage/hypothecation.

Salam sales are suitable for financing agricultural operations, where the bank can transact with farmers who are expected to have the goods for delivery after harvesting, either from their own crops or from the crops of others, which they can purchase in the latter case and deliver in case their crops fail. *Salam* sales are also used to finance commercial and industrial activities, and have the advantage of elasticity to cover the needs of people working in various sectors of the economy, such as farmers, industrialists,

contractors or traders. They can cover the financing of overheads and capital goods as well.

Istisna'a

Istisna'a is a contractual agreement to manufacture goods, allowing cash payment in advance and future delivery or a future payment and future delivery. *Istisna'a* can be used for financing in the manufacture or construction of houses and factories, and in building bridges, roads and highways.

The key features of *istisna'a* include the following:

- It is used in the manufacturing sector where the *al-saani* (manufacturer or the seller) would arrange to provide both the raw material and the labour;
- The goods and price must be known and specified to the extent of removing any *gharar* or excessive uncertainty;
- It is not necessary in *istisna'a* that the price is paid in advance. The price can be paid in instalments within a fixed time period;
- It is not necessary for the *al-saani* to manufacture the goods. The seller may enter into a contract with a manufacturer to provide the same goods, which is the subject matter of the first *istisna'a* contract;
- In an *istisna'a* contract, before a manufacturer starts the work, any one of the parties may cancel the contract by giving a notice to the other; however, once the manufacturer has started the work, the contract cannot be cancelled unilaterally;
- The *al-mustasni* (purchaser) has the right to obtain collateral from the *al-saani* for the amount paid and with regard to delivery of the goods with specifications and time; and
- The contract may also contain a penalty clause on account of breach of the contract.

Istisna'a contracts have wide fields of application for Islamic banking institutions to finance public sector needs. The *istisna'a* contract is suitable for various industries, such as the aircraft industry, locomotive and ship-building industry, construction industry and food processing industry.

Diminishing musharaka

Diminishing *musharaka* is a variant of *musharaka*, and is a form of co-ownership in which two or more parties share the ownership of a tangible asset in an agreed proportion, and one of the co-owners undertakes to buy, in periodic instalments, the proportionate share of the other co-owner until the title to such tangible asset is completely transferred to the purchasing co-owner.

It is a combination of partnership and *ijara* (leasing), where the asset under co-ownership is leased by one of the parties to another before the asset can be fully acquired. It is mainly used by Islamic banking institutions for house and car financing; however, it could also be used for financing in the purchase of industrial establishments, farms and other fixed assets.

The key features of the diminishing *musharaka* are given below:

- Diminishing *musharaka* is applied for the purchase of tangible assets;
- Proportionate shares of each co-owner must be known and defined in terms of investment;
- Expenses incidental to ownership may be borne jointly by the co-owners in the proportion of their co-ownership;
- Losses, if any, shall be borne by the co-owners in proportion of their respective investments;
- Each periodic payment shall constitute a separate transaction of sale; and
- Separate agreements/contracts shall be entered into at different times in such manner and in such sequence so that each agreement/contract is independent of the other, in order to ensure that each agreement is a separate transaction.

In diminishing *musharaka*, the bank (as financier) and a client participate either in joint ownership of a property or an asset that allows the client to secure the sole ownership of that asset over a period of time. The share of the bank is divided into a number of units and it is understood that the client will purchase such units periodically. Thus, reducing or "diminishing" the bank's share in the ownership and increasing the client's ownership until all of the bank's units are purchased, so as to make the client the sole owner of the asset. This arrangement allows the financing bank to claim rent, on a reducing basis, from the client for using the asset according to the proportion of the prevailing ownership in the property, and at the same time allows periodical return of a part of bank's investment through purchases of the units representing the bank's share of the asset.

Ijara

Ijara is equivalent to conventional leasing; however, there are some key differences, such as the requirement of the lessor to assume the risk relating to ownership of the leased asset at all times, and any sale to the lessee at the end of the lease period to not be a condition of the leasing contract. The bank's income is derived from the profit charged on the cost of a leased asset, and this profit is included with the cost in the lease repayments. Although *ijara* is strictly not a financing mode, Islamic banking institutions are extensively using it as such to acquire fixed assets for their clients because it does not involve interest payments, is easily understood and can be used in order to obtain tax concessions in certain countries. The question as to

whether or not the transaction of leasing can be used as a mode of financing in the context of Shari'a will depend on the terms and conditions of the contract.

Conclusion

Islamic finance is quite different from conventional finance, based on Shari'a injunctions, and is strictly against exploitative transactions that involve *riba*, excessive uncertainty, speculation and debt trading. Islamic finance is based on "material finality", which implies a strong link between the financial transaction and real economic activity. This link insulates Islamic finance from overheating and creating asset price bubbles that have led to financial crises.

Islamic financial products provide a multitude of alternatives to conventional finance, and have been re-engineered in such a way that creates conformity to conventional finance with comparability of returns. Innovations, such as *sukuk* (Islamic bonds) and diminishing *musharaka*, are structured so as to combine features from two or more Islamic financial contracts. These combination structures are designed to suit the financing requirements of various clients on both the consumer and corporate sides.

Islamic banking, based on Shari'a, prohibits interest in all its forms and emphasizes trade as the major focus of all economic activities. Shari'a does not allow rent-seeking behaviour on capital, whilst the rewards are tied-up with risk taking – there should be no reward without assuming risk. The Islamic economic system strives to achieve a socially responsible economic order, the eventual goal of which is value creation through ethical business activities besides ensuring equal economic opportunities, especially for the deprived segments of the population. This requires a paradigm shift from a focus on debt-based financial intermediation to participatory modes.

1.4

The Institutional Infrastructure Supporting the Islamic Finance Industry

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Introduction

There are four major international institutions concerned with the Islamic finance industry:

1. The Fiqh Academy;
2. The Islamic Development Bank;
3. The Islamic Financial Services Board; and
4. The Accounting and Auditing Organization for Islamic Financial Institutions.

The role and significance of these institutions is reviewed here, together with other major organizations providing data and information on Islamic finance. In terms of education and training, institutions providing professional qualifications in Islamic finance include:

- The Institute of Islamic Banking and Insurance, UK;
- The International Centre for Education in Islamic Finance, Malaysia; and
- The Chartered Institute of Management Accountants, based in the UK but with worldwide offices, which launched a certificate in Islamic finance in 2007.

There are also universities offering academic qualifications in Islamic finance, such as the International Islamic Universities in Malaysia, Pakistan and Bangladesh, and the CASS Business School, UK, which has an Islamic finance stream for its executive Masters in Business Administration (MBA) offered in Dubai. The Faculty of Islamic Studies in Qatar is launching a Masters of Science (MSc) in Islamic Finance in September 2008. Postgrad-

uate research degrees, including at PhD level, are offered by Durham University.

The Fiqh Academy

To determine whether financial products comply with Shari'a, the opinions of scholars trained in Islamic jurisprudence (*fiqh*) are sought. Their rulings, or *fatwa*, are regarded as definitive, but as Islam is not a centralized or hierarchical religion, there are many competing, and sometimes contradictory *fatwas*. It was to resolve these conflicts that the Islamic Fiqh Academy was established in Jeddah in January 1981. Its mandate was agreed by the Organization of the Islamic Conference, which now serves 57 Muslim majority countries. The Islamic Fiqh Academy is therefore widely regarded as the appropriate international institution to provide guidance on moral issues of concern to the Muslim faithful. This includes guidance on medical ethics, social issues and economic matters, including finance.

Its rulings on finance are respected by the Shari'a board members of leading Islamic banks and *takaful* (insurance) operators. Notable rulings include those on the permissibility of deposit or down payment subscriptions and foreign exchange transactions, bank deposits and investment in equities, and leasing contracts. The issue of whether credit cards are permissible has also been addressed at several meetings. As the issues considered are often complex, it is not merely a matter of ruling whether a financial product or activity is permissible, but the terms under which it is permissible.

For example, in leasing (*ijara*), an operating lease is permissible as the owner of the asset has responsibility for its maintenance, which justifies the rental payment, whereas with a pure financing lease all the obligations are devolved to the lessee, invalidating the contract. Similarly, credit cards that involve *riba* payments are forbidden, but paying a subscription for a predetermined credit limit is permissible. Sometimes, *fatwas* have been taken forward by other bodies, as with the ruling on the permissible equity investments which resulted in the Dow Jones Islamic Indexes developing their methodology to determine what business sectors are permissible for investors who want to be Shari'a-compliant. The question of financial screening to avoid excessive exposure to *riba* was also further refined by the Dow Jones Islamic Indexes.

The Islamic Development Bank

Founded as a development assistance agency following a conference of finance ministers in 1973, the Islamic Development Bank (IDB) started operations in 1975. The original remit was to facilitate poorer Muslim countries to pay for their oil imports after the substantial price rises of the mid-1970s, with most of this financing being provided on a *murabaha* basis.

The IDB bought oil and sold it to importing countries at a modest mark-up. By the 1980s, the IDB was involved in more diverse trade financing operations, using *ijara* as well as *murabaha*, and from the 1990s it has offered project financing through *istisna'a*. This involves the IDB making payments to contractors, sub-contractors and suppliers to a project, with the repayments plus a mark-up being made once the project is complete and yielding returns. Such financing has been used for power generation schemes, transportation and communications projects and other diverse infra-structure developments.

Saudi Arabia accounts for over one-quarter of the subscribed capital of this Jeddah-based institution, Iran being the second largest subscriber with almost 10 per cent of the capital. The Islamic Republic views the IDB as a concrete symbol of its cooperation with its Gulf neighbours in helping to promote Islamic finance worldwide.

The IDB raises additional finance from Islamic banks through its specialized funds, such as the Islamic Bank's Portfolio for Investment and Development and the Unit Investment Fund, and it has also issued s*ukuk* Islamic securities to secure further capital. It invests in *waqf* religious endowments, and has programmes for poverty reduction as well as scholarships for postgraduate students from poorer Muslim countries attending recognized universities. Its affiliate, the Islamic Research and Training Organization, provides organizational back-up and sponsors numerous Islamic finance conferences. The IDB has evolved into a World Bank for Muslim countries; indeed, it co-funds with the World Bank and other development assistance agencies.

The Islamic Financial Services Board

Islamic financial assets and liabilities have different risk characteristics to their conventional equivalents, which poses a challenge for regulators. The Islamic Financial Services Board (IFSB) was established to advise regulators on how Islamic banks and other Shari'a-compliant financial institutions should be managed, and how international regulatory requirements should be adapted for this distinctive type of banking institution and financial products. Since its inception in November 2002 in Kuala Lumpur, almost 40 regulators have become members, as well as 108 market players and institutions such as the Bank for International Settlements, the International Monetary Fund, the World Bank and the IDB.

The IFSB has already issued detailed standards, following studies identifying best practice and widespread consultations with the Islamic financial services industry and beyond. These standards cover the following:

- Capital adequacy in relation to Basel I and II requirements;
- Risk management, including credit, operational and market risk; and
- Corporate governance.

It is currently drafting new standards to cover *sukuk* securities, Shari'a compliant investment funds, *takaful* operations and Shari'a governance. The aim of the IFSB is to spread awareness of regulatory challenges within and beyond the Muslim world. The Financial Services Authority of the UK has taken an active interest in its deliberations. As the Islamic finance industry involves many cross-border transactions, the need for international standards has become more urgent, and the IFSB has played a major role in facilitating harmonization and convergence of regulatory practices.

The Accounting and Auditing Organization for Islamic Financial Institutions

Financial reporting for Islamic financial institutions is also challenging because of the unique nature of their assets and liabilities. There is the question, for example, of whether *murabaha* assets should be valued at their cost to the bank or their cost to the client, which includes the mark-up. The relevant Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standard suggests the latter. Similarly there is the issue of whether income from *murabaha*, *ijara* and *istisna'a* assets should be booked as it accrues, or at the end of the period when the financial institution has its funding returned. Again, AAOIFI suggests the former.

AAOIFI was established in Bahrain in March 1991 to support the Islamic financial services industry, and its standards are now mandatory in Bahrain, Qatar, Jordan, Lebanon, Sudan and Syria, as well as being implemented by the Dubai International Financial Centre. The regulatory authorities in Saudi Arabia, Indonesia, Malaysia, Pakistan, Australia and South Africa have issued guidelines based on the AAOIFI standards. To date, AAOIFI has issued 22 accounting standards, five auditing standards, four governance standards and two codes of ethics. It has also issued 21 Shari'a standards that were approved by its own Shari'a board.

The aim of AAOIFI is not to replace the International Financial Reporting Standards (IFRS), but rather supplement them with respect to Shari'a-compliant assets and liabilities and the income flows associated with these. Even in jurisdictions where AAOIFI standards are not mandatory, most Islamic financial institutions implement them in practice, and refer to AAOIFI in their annual financial reports and interim reports. As with the IFSB, as leading Islamic banks expand beyond their countries of origin, a consistent set of accounting standards facilitates the consolidation of their financial statements, which is helpful for both their shareholders and the regulatory authorities.

Other stakeholder groups are also important to AAOIFI, such as the investment *mudaraba* account holders with Islamic banks who earn a profit share. They are entitled to know the basis of how the profit share is calculated, and the amount placed in the profit equalization fund from which

they may benefit in the longer term, but at the expense of a smaller profit distribution in the short term. AAOIFI sponsors an annual Islamic finance conference in Bahrain, and organizes regular training sessions for accountants where its standards are explained.

Information sources

There are comprehensive news and data sources serving the Islamic financial services industry. Online subscription services include the Islamic Finance Information Service (IFIS) of ISI Emerging Markets, which is a Euro-money affiliate based in London, and Islamic Finance News (IFN), based in Malaysia. IFIS provides comprehensive information, including data on *sukuk* issuance, managed funds, syndications and *takaful*. The annual reports and interim statements of most Islamic banks can be accessed through it, as can legal reports, supervisory documents and research materials. The databases within the system can be searched by year, country and product. IFN provides a weekly newsletter covering the latest developments in the industry, with historical information also available online. It contains interviews with industry leaders, and a forum where topical questions are addressed by a number of professional and academic specialists.

There are three major print magazines on Islamic finance:

1. New Horizon, the publication of the Institute of Islamic Banking and Insurance (IIBI) in London;
2. Islamic Business and Finance, published by CPI Financial; and
3. Business Islamica, published by Tradewind.

Both Islamic Business and Finance and Business Islamica are located in Media City, Dubai. Islamic Business and Finance and Business Islamica are published monthly, whilst New Horizon has become a quarterly publication. All are largely funded by advertising, although Business Islamica has a nominal newsstand price. New Horizon is the longest established, as it has been published continuously since 1991 with features and regular items including a news round-up, details of IIBI lectures, appointments, a calendar of events and questions and answers. All three contain articles and interviews, with Islamic Business and Finance employing its own journalists, but much of the New Horizon and Business Islamica material outsourced. Islamic Business and Finance is organized into separate sections on capital markets, Islamic funds and takaful, with each edition containing an editorial and at least one interview.

Professional qualifications

The IIBI Diploma in Islamic Finance is the oldest established professional qualification, and over 1,000 students have enrolled since the early 1990s. It is accredited by the Open and Distance Learning Quality Council in the UK, and recognized as a professional qualification. There is no need to attend classes; rather, busy professionals can work at their own pace through the materials prepared by experts. Progress is monitored through periodic question papers sent to those who enrol, with completed answers to be returned by email or post.

In 2007, the Chartered Institute of Management Accountants (CIMA) launched a new Certificate in Islamic Finance in the UK, Bahrain and Malaysia. Although an accountancy body, the modules cover most areas of Islamic finance, with assessment taking place through online, multiple-choice questions. Compulsory study modules include Islamic commercial law, banking and *takaful,* Islamic capital markets and instruments and accounting for Islamic financial institutions. Detailed study guides are provided for each module, including glossaries of Islamic finance terms, illustrations of how practice is derived from theory, and a step-by-step approach linked to specified learning outcomes. The study guides contain extensive case-study materials, chapter summaries, revision sections and full length mock examinations, consisting of 40-50 questions.

The International Centre for Education in Islamic Finance (INCEIF), based in Malaysia, offers a Chartered Islamic Financial Professional programme with both on-campus study and distance learning. The structured programme involves three parts; the first part stresses basic knowledge leading to associate membership, the second involves skills acquisition resulting in proficient membership on completion, and the third building competency and experience resulting in practising membership. The courses take between one and a half to six and a half years to complete. First stage modules include Islamic economics and finance, Islamic financial institutions and markets, Islamic finance regulations and governance, applied Shari'a in financial transactions, deposit mobilization and financial management and wealth planning. The subject skills at level two include structuring financing requirements, issuing and managing Islamic securities, Shari'a compliance and audit, customer relationship management and the role of technology and issues in Islamic financial institutions and markets. At level three, participants are articled to participating Islamic financial institutions to gain practical experience, with validation involving problem solving, restructuring exercises, simulation and management games, product conversion and interviews.

Academic programmes

The International Islamic University of Malaysia has undergraduate programmes in economics, accounting and business administration that enable students to get some exposure to Islamic economics and finance, although most of the course contents are conventional. At postgraduate level more specialized study in Islamic finance is possible, as is the case with the International Institute of Islamic Economics located within the International Islamic University in Pakistan, which offers a one year Postgraduate Diploma in Islamic Banking and Finance through evening study, as well as an MSc over three years with scheduled morning classes.

The UK-based CASS Business School launched an executive MBA with an Islamic finance stream in 2007. The programme is offered in Dubai in collaboration with the Dubai International Financial Centre. The two-tier programme involves established MBA modules in accounting, marketing, finance and business economics, with the Islamic finance options coming near the end of the course. The three specialist components are in Islamic economics, Islamic banking and finance and Islamic law of business transactions. In neighbouring Qatar, the Faculty of Islamic Studies, which is sponsored by the Qatar Foundation, is adding an MSc in Islamic Finance to its existing masters programmes in Islamic Studies from 2008 onwards. The new faculty is separate from the University of Qatar, but will be moving to the new Education City in Doha once its buildings are completed. Details of the new degree structure are not yet finalized.

For research degrees in Islamic finance, Durham University in the UK has become the leading international centre, attracting suitably qualified applicants from throughout the world, including Malaysia and the Gulf. A master's degree by research is offered at the university, which involves students writing a thesis of 30,000 words on an Islamic finance topic that they can negotiate with their supervisor. Doctoral degrees involving a minimum of three years of supervised study are also offered, with students writing a thesis of 80,000 words. There are dedicated research support workshops and a module on Islamic political economy and Shari'a compliant finance that students are expected to attend. PhD students spend part of their first year in Durham, but during the second and third years they often undertake fieldwork in their country of origin or elsewhere, as most of the research involves empirical studies.

PART TWO

Islamic Finance in Practice

2.1

Retail Banking: Current and Savings Accounts and Loans

Roderick Millar

Introduction

Retail banking covers the wide range of services commercial banks offer to private individuals. For the vast majority, this does not go much further than a current account, possibly a savings account and access to various loans for everyday items (overdrafts) and larger items (car loans, home improvement loans, etc).

Islamic finance started as an experiment, perhaps even a slightly cynical marketing experiment, in building a retail bank. The Mit Ghamr Savings Association in Egypt ran for a few years in the mid-1960s and achieved great initial success, but a change in the political climate led to the bank being closed down. It sold itself as offering a way for Egyptian farmers to save money within a Shari'a-compliant framework, and the rural devout of Egypt found this attractive. At the same time in Malaysia, the Tabung Haji was established offering individuals a way of saving to go on the Hajj pilgrimage with their savings invested in a Shari'a-compliant way.

The oddity is that the growth and development of Islamic finance, despite these early institutions, has been a top-down process and not one that has developed from serving the public at large first. The real growth in Islamic financial institutions over the last 25 years has come from financial products aimed at large infrastructure projects of governments and large corporations, resulting from the high liquidity of the Muslim oil surplus countries. This has expanded more recently into investment products, again for the institutional market and more sophisticated investors. Only in recent years have products designed for private individuals really appeared on a widespread basis, and much of this development has been intended for high net-worth bank customers.

The advance of simple current and savings accounts and personal loans is the latest stage in Islamic finance's development into a mainstream sector of banking. It should eventually be the most significant sector, at least in terms of the numbers of people involved on both the customer and supplier sides, if not in raw cash terms. Islamic retail banking is really the "coming of age" of Islamic finance.

What sets one retail bank apart from another? In essence the actual products – current and savings accounts and personal loans, as well as credit cards and mortgages (which we cover in other chapters) are all fairly straightforward financial products. In technical terms, the only differences will be in the rates of interest they are charged out at. Clearly these are not part of the Islamic equivalent products as *riba* (interest) is prohibited. This leaves customer service as the main product differentiator – and is something that banks are always keen to promote their excellence in, even if they sometime fall short of the mark in reality.

The main retail banking products in Islamic form

Current accounts

This most basic form of bank product does not necessarily require any particular changes to be made from a conventional current account to make it a Shari'a-compliant one. In many countries, it is not expected that conventional current account deposits will earn interest – and equally it is not allowed for account holders to have overdrafts. In these circumstances, no interest elements are involved in such conventional current accounts; these accounts sole purpose is to provide a safe place for the account holder to hold their money and to pay their earnings and other income into and from which to draw money for cash and through cheques and electronic withdrawals and payments.

Islamic current accounts are no different in practice to these basic conventional accounts; they offer the account holder a way of managing their earnings and payments so that they can operate in today's economy. No interest is applied at any stage.

It is attractive to banks to offer these services even if they cannot earn any money from them, as they build relationships with the customers that they potentially can develop into use of other services for which fees can be charged. The account holders' deposits also help to strengthen the banks balance sheet which improves its ability to meet regulatory requirements and potentially lend money profitably elsewhere.

Banks do run the risk of account holders overspending with unapproved overdrafts; in these circumstances pre-defined "management" fees are usually applied and in certain circumstances "penalty" fees can also be charged to disincentivize the account holder from creating an overdraft situation. While management or administration fees are usually retained by the bank to cover their costs, penalty fees will normally be paid into a charitable account so that the bank, the lender, does not profit from the borrower which would be contrary to core *riba* principle.

Most Islamic current accounts will provide cheque books, debit cards and allow direct debits and standing orders to be permitted. Internet and telephone access to accounts is also standard.

Savings accounts

Savings accounts in conventional banking attract higher rates of interest from the bank to the saver than might be available in an interest paying current account. They usually will not offer any form of lending (overdraft). Competition to provide the most attractive rate of interest is strong in conventional banking, and usually the higher rate accounts have more restrictions in terms of the frequency of times withdrawals can be made and in what form they can be made.

An Islamic savings account is structured completely differently from a conventional savings account. An Islamic savings account is in fact an investment account, where the bank invests the money deposited in the account. This is a straightforward *mudaraba* process. *Mudaraba* is where the provider of the funds, the saver, entrusts their money to an expert investor, the bank, so that they can make a profit from it.

The bank will pool all such savings account money and invest it collectively in Shari'a-compliant businesses. The profits from such investment are then shared between the saver and the bank. How the profits are distributed between savers and the bank will depend on the contract applicable to the account. The amount returned will vary according to the profit generated and will be paid to the saver usually as a percentage figure based upon the lowest balance retained in the account during the period of calculation, whether that be a month, quarter or year. In the event of a loss occurring then the saver will lose money but under most terms the bank will not.

The fact that the holder of the savings account may lose capital indicates that Islamic savings accounts are very different products to conventional savings accounts where deposits held in a conventional savings account would only be lost in the event of the bank itself going into liquidation (and even then most banks have such deposits insured by central bank schemes to a certain extent).

Personal loans

The third major product of retail banking is that of secured loans to private individuals. Secured loans are those that are guaranteed by the value of an underlying asset. The most obvious secured loan, although it is not commonly referred to as such, is a mortgage where the bank lends a significant sum of money to the lender to purchase an asset, usually property, but retains the right to take ownership of it if the borrower is unable to repay the loan amount. Other secured loans would be a car loan, where the ownership of

the car is retained by the bank until the loan is repaid. Unsecured loans do not have such assets to guarantee the repayment of the loans and as such are charged at considerably higher levels of interest in conventional banking products.

Clearly in Islamic banking loans cannot be made through the same structure as in conventional banking. If interest cannot be charged the whole loan structure as it exists in conventional banking is void. For this reason retail banking customers requiring funds through an Islamic-compliant product have to apply for loans that are rather more complex.

The most popular retail loan is made through a *murabaha* contract or process. The *murabaha* sale contract allows the seller of a good to make a profit on a transaction and requires the profit margin to be agreed at the outset of the contract. In banking, this at its simplest form would mean that the bank customer approaches the bank and seeks funding to purchase a particular good or asset, say a car or a new kitchen or a household good. The bank would then purchase the good from the supplier or manufacturer and immediately resell it to the bank customer at a pre-agreed cost-plus profit price. The customer would then be contracted to repay the bank in instalments over an agreed time period. This deferred payment in return for a higher cost of the original good is an acceptable arrangement in Shari'a. In *murabaha,* the ownership of the goods would pass to the customer who will be liable for all expenses related to it; however, the good will be pledged to the bank as security.

The drawbacks with *murabaha* are that the repayment terms are inflexible. Unlike with a conventional interest-bearing loan which may be repaid early with a consequent reduction in the interest charge, a *murabaha* contract is made for a fixed price which will not vary regardless over what time the payments are made. Although the contract will stipulate a schedule for the repayments, there will be no reduction for the bank customer should they repay it early (and so no incentive to do so) and similarly there are, in its purest form, no cost penalties should the customer miss a payment or take over the due period to repay the cost of the asset.

There are a couple of incentives/penalties that are sometimes imposed. A "negative penalty", which is applicable for other financing transactions, where if the customer makes all their payments in full and on time then they may gain a reduction in the final cost or some other benefit; or a "charity fine" where any missed payments, etc, incur a payment to a charitable institution nominated by the bank.

For larger items and fixed property assets, there is an alternative contract available to retail bank customers to provide funding. This is *ijara* or lease-to-purchase.

Unsecured loans to customer are offered by use of *bai al-inah* (sale and buy-back) or *tawarruq. The bai al-inah* structure, normally used in Malaysia for personal financing, is also a mechanism for customers to obtain immediate cash from Islamic banks. *Bai al-inah* transactions are between a bank and a customer, without involving an intermediary. It involves the bank selling

a commodity to the customer on a deferred payment price, and the bank subsequently buying back the commodity to the pay the customer a cash price, which is lower than the deferred price. It can also be applied when a customer sells a commodity to a bank on a cash basis and then buys back the same asset on a deferred payment basis. In other words, it is simply a sale by one party at a higher price on deferred payment, and then buy-back at a lower price (and vice versa) to realize immediate cash for the other party. However, this structure is questionable in other Islamic finance markets, such as the Gulf Cooperation Council region and South East Asia, and is considered contrary to Shari'a rulings by some, as it involves dealings between two parties for the purpose of generating cash between them by using a financing structure where the only purpose is to obtain cash and purportedly distinguishing interest in the bank's deferred payment price.

Therefore, in those markets, a variant of the *bai al-inah* contract (often referred to as reverse *murabaha* or *tawarruq*) is now also common in retail banking for obtaining cash through personal financing. In *tawarruq*, the bank purchases an amount of a tradable commodity, say £5,000 of a metal, that is equal to the amount a customer is seeking as a loan. The commodity is purchased at a financial commodity exchange, such as the London Metal Exchange, and resold to the customer for a specified cost, plus a mark-up amount, say a 10 per cent profit of £500. The customer does not pay the bank the new price of £5,500 for the quantity of the metal but contracts to pay them in deferred instalments over a specified period as in the example above. However, once the customer has contracted to this the metal becomes their property – of course the customer does not actually want £5,000 of metal, so the customer, or the bank on behalf of the customer, arranges to sell the metal through an authorized broker for the prevailing market price of £5,000. This amount is then transferred to the customer's bank account.

It is different from *bai al-inah*, which is normally practised in Malaysia, as it involves a third party and the purchase and resale are considered to be independent of each other. The permissibility of using this mode is on the basis that in the past, Islamic jurists have allowed *tawarruq*; however, there are concerns. An important concern is explained by Munawar Iqbal in "A Guide to Islamic Finance" (2007) below:

> "...the way this instrument is being practised by banks is very different. It appears to be simply a "devious artifice" (*hilah*) to get around the prohibition of interest through an intermediate process, the end result being what was prohibited... The few scholars who have allowed *tawarruq*... require the banks to actually buy and at least take constructive possession of the commodities, and then sell them."

Tawarruq has three main attractions; it is very flexible, and the customer can acquire virtually any amount of money through this process as commodities such as metals can be bought at any amount. It does not require

the original seller of the desired asset, eg. the car, kitchen or holiday, to be involved so simplifying the transaction in terms of guarantees and resale values. And finally it enables the bank customer to borrow money for non-specific items.

Conclusion

Islamic banking has developed in market terms from the top-down. Growth over the last three decades has been seen in the development of large corporate bond issues and more recently the growth of investment products to sophisticated investors. High net worth individuals have driven the growth of the personal finance products but it is the burgeoning of mass market retail banking that will finally cement Islamic banking into the mainstream of the financial sector.

Islamic retail banking is growing as Islamic regions experience a rapid growth in their middle class populations. The huge increase in the oil price also has had its effect on the Gulf region economies, bringing more people into a position where they have the opportunity to make a choice in how they handle their personal finances. This increasing sophistication is driving the growth of Islamic banking in Asia and the Gulf region. In the UK, Western Europe and North America, there is also a growing appetite from Muslim residents for more appropriate banking facilities to meet their religious requirements. All these factors have made Islamic finance the fastest growing sector of the global retail finance sector; Yasaar Research have estimated the sector will account for some 12 per cent of global finance by 2015.

2.2

Personal Finance: Credit Cards

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Introduction

A credit card can be defined as a method of payment that a card issuer gives to its customers to make purchases and/or withdraw cash. The issuer pays for the transaction and then bills the customer for the amount. The cards are called credit cards as they provide a loan to the customer. "Credit" can be defined as the provision of resources (such as granting a loan) by one party to another party, where that second party does not reimburse the first party immediately.

Credit cards can be used in two ways:

1. Withdrawing cash from an automated teller machine (ATM) – here, the card issuer gives cash to the cardholder as a loan and asks him/her to repay it on a specific, later date. The issuer charges the customer a cash advance fee which is either a fixed amount, or a percentage of the total loan amount; or
2. Buying products or renting a service – here, the issuer pays the purchase amount or the rent amount to the merchant on behalf of the cardholder and considers it as a loan on the customer. The issuer will then ask the cardholder to pay it on a later, specific date. In these kinds of transactions the issuer does not charge the customer any fee. Instead the merchant is charged a percentage of the total amount.

Credit cards can be classified according to their loan repayment method, as either full or partial loan repayment cards.

Full loan repayment cards

With this type of credit card, the holder has to pay the entire amount due in full on the due date after the grace period. This type of card is also called a charge card. This type of card is *halal*, given two conditions are met:

1. The agreement between the issuer and the cardholder should not state

that the cardholder pays any late fees where payment has not been made on time. This is considered *riba* because the loan amount will be increased at repayment; and

2. The cardholder does not withdraw cash using the card in case the issuer charges a fee as a percentage of the withdrawal amount.

The fee an issuer accepts from the merchant is allowed since it is a commission (*samsara*), either as a percentage of the loan amount or as a fixed fee.

Partial loan repayment cards

With this type of credit card the holder can pay a percentage of the due amount at the due date after the grace period. The issuer will add some percentage to the loan amount for giving this revolving capability. This type of card is *haram* (forbidden), since the issuer adds a percentage on the loan amount because of the delay in payment and this is a pure *riba*.

Sources of revenue

Credit cards are one of the most profitable products in the banking sector; net profits can reach more than 26 per cent per annum. These profits come from six main sources:

1. Annual and subscription fees;
2. Interest;
3. Penalties for late payments or overdue amounts;
4. Interchange fees;
5. Fees for cash withdrawal; and
6. The exchange difference coming from foreign currency purchases.

Islam does not approve all of these six sources. This section will examine each one in more detail and look at its feasibility from the point of view of the two Islamic schools of thought. The first school is the "liberal school" which takes the Quran and *Sunnah* literally, and allows things without taking the current situation and the reality surrounding it into consideration. The second school is the "conservative school." This also takes the words of the Quran and the *sunnah* literally, but also considers the reality behind them, the current situation and decides whether to allow or prohibit actions.

Usually the "conservative school" will not allow something that is prohibited by the Quran and *Sunnah* if the situation dictates, since these two sources have the final say. However, if something is allowed in the Quran and *Sunnah* but the conditions being presented might make it harmful for people or may lead to something that is eventually prohibited,

they will not allow it. For example, selling knives is allowed in Islam, but in some situations (eg. if the vendor is sure that the one who wants to buy the knife is going to harm or kill someone with it) it is prohibited to sell knives.

The "liberal school" takes the opposite stance; if something is allowed, then there is no need to look for a reason to prohibit it. If it is *haram*, they will look and see if a need for it exists in society and find a way to make it *halal* (permissible).

Both schools are acceptable in Islam. However, depending on the subject, the *fatwa* that people will follow may differ. As stated before, *riba* means taking interest on loans and is something expressly forbidden in Quran. For that reason, most Muslims prefer to go with the "conservative school" when it comes to the issue of *riba*.

Description of the six sources of revenue

Annual and subscription fee

Cards issuers claim that this fee is the administration cost for the card for one year (that is why they make an annual charge). It is clear that this is not the true cost, since they charge different fees for different types of cards (eg. classic, gold, platinum, etc.) even though the administration overhead is almost the same for all types of cards.

The "liberal school" allows banks to take any fee they like by saying it is not *riba*; it is a fee for a service the bank or credit card issuer is providing to the customer. However, the "conservative school" does not accept this argument and rules that if a bank wants to charge for it, then it must be the actual cost.

This latter view makes more sense. Take the case of someone who wants to borrow an amount from a friend (eg. $100 in the form of traveler checks). The lender needs to post it to the borrower and the post cost is $10, but the lender decides to charge the borrower $45. Since the cost of the post is only $10, this will be a clear *riba* to give $110 and take $145.

Interest

Interest can be defined as "a charge for borrowed money, generally a percentage of the amount borrowed". Thus it is clear that banks and credit card companies are not allowed to take interest, since it is pure *riba,* and neither of the two schools allow it.

Penalties for late payments or overdraft amounts

These charges are also not allowed by both schools since asking for more than the loan amount is *riba*. Even if the customer's payments are late, issuers should not take more than what they actually gave as a loan. Some