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Shari'ah Compliant Banks

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INTRO

Islamic banking derives its rulings and principles from the *Quran* (the Holy Book of Islam) and *Sunnah* (the prophetic traditions). Strict Islamic banking and finance must adhere to the tenants of *Shari'ah* law, or Islamic jurisprudence (*fiqh*). *Shari'ah*'s basic principles outlaw speculation, contractual uncertainty, and transactions which may result too advantageous to one party at the expense of another. It also forbids investment in goods deemed harmful to the good of society such as gambling, pork, pornography, tobacco, alcohol, arms and anything else, which the *Shari'ah* deems unlawful.

The most significant and important difference between modern finance and Islamic finance is the prohibition of payment or earning of interest (*riba*, a term that encompasses not only the concept of interest, but also that of usury), because it is earning money without having to do any work for it: *Shari'ah* considers interest unethical because it is a form of wealth creation which has no tangible basis, creating a 'virtual' economy, founded on money and indebtedness, as opposed to a 'real' economy. This is in stark contrast with modern finance in which interest is one of the key methods by which banks make money through their products such as mortgages and personal loans. Emphasised instead is profit and loss sharing between parties.

It was in Dubai in 1975 that Islamic banking came to life in the true sense of the term, and it has since taken the world by storm. The differences between Islamic and conventional banks have become all the more important since an increasing number of local and foreign banks in the region have started their own separate Islamic institutions or are testing the market through "Islamic windows".

Due to the detailed nature of Islamic law, institutions in the Islamic financial market will often appoint a *Shari'ah* Board, which comprises scholars versed in both Islamic jurisprudence and economics, to vet proposed transactions for acceptability. The religious boards have both supervisory and consultative functions.

BASIC FEATURES

In Islamic finance, money can only earn returns if used in productive or real investments. This explains why deposits in banks cannot earn interest. Still, prohibitions are made against guaranteed and predetermined rates of return. Conversely, Islamic finance encourages risk-sharing and entrepreneurship**.**

Some of the salient features may be summed up as:

- The individual's right to seek economic well-being: Islam makes a clear distinction between what is *halal* (lawful) and what is *haram* (forbidden) in pursuit of an economic activity. In broad terms, Islam forbids all forms of economic activity, which are morally or socially injurious.
- The individual's right to ownership of wealth legitimately acquired: Islam makes it obligatory on the individual to spend his wealth judiciously and not to accumulate it, keep it idle or to dissipate it. Besides, Islam seeks to prevent the accumulation of wealth in a few hands to the detriment of society as a whole, by its laws of inheritance
- The individual's right to retain any surplus wealth: Islam seeks to reduce the margin of the surplus for the well-being of the community as a whole, in particular the deprived parts of society by participation in the process of *Zakat* (one of the five pillars of Islam, an obligation on Muslims to pay 2.5% of the minumum wealth which they have had for a full year) .

Viewed as a whole, the economic system envisaged by Islam aims at social justice without inhibiting individual enterprise. The Islamic financial system employs the concept of participation in the enterprise, utilizing the funds at risk on a profit-and-loss sharing basis. Besides, financial institutions must practice a careful investment policy, diversification of risk and prudent management. The concept of profit-and-loss sharing, as a basis of financial transactions, encourages better resource management.

Despite the various existing differences of interpretation, it is generally agreed that commercial transactions should be concluded:

a) at a price that is agreed mutually and not under duress;

b) between parties that are sane, and that are old enough to understand the implications of their actions

c) without uncertainty or deception with regard, for example, to the quality of the goods or the seller's ability to deliver them (hence, short-selling is prohibited and the general requirement arises that, at the time of contracting, the goods transacted should be in existence, under the ownership of the seller and in the seller's physical or constructive possession);

d) the contract should not be based upon a countervalue that is itself prohibited under Islamic law.

In order to comply with *Shari'ah* tenants, Islamic banks have a whole set of primary products for their clients. These include:

- ***Murabahah***: This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. Basically, the client purchases a commodity from the bank at a deferred price, which includes the agreed profit margin or mark-up. In theory, Islamic banks couldn't charge additional profit on late payments (as it would be considered interest, therefore prohibited). *Shari'ah* scholars, though, have noted how delay penalties act as an effective deterrent against this failure to pay. They have since agreed to allow Islamic banks to charge such penalties on their customers' past-due obligations. This has been approved with the condition that the amount collected through these penalties will not be added to Islamic banks' profit, but must be donated to charity in a transparent manner, so that the customer receives proof that the penalty charged has actually been given to a charity. However, the asset remains as a mortgage with the bank until the *Murabahah* is paid in full. *Murabahah* accounts for 75% of Islamic financial activities such as purchase of cars and houses. Micro-lending institutions founded by Muslims, notably Grameen Bank, are based on *Murabahah* (and also on *Musharahah*).
- ***Ijarah*** (Lease): Generally, under this concept, the bank makes available to the customer the use of service of assets/equipments, owned by the bank, such as plant or motor vehicle for a fixed period and price. *Ijarah* enables the client (lessee) to have the use of the equipment on payment of the first rental.
- ***Istisna***: The bank constructs an asset (through a third party) and then sells the asset to the client at a predefined price that includes cost and an agreed profit.
- ***Salam***: *Salam* is a particular contract in which advance payment is made for goods to be delivered later on. The seller commits itself 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. First of all, it is necessary for the validity of *Salam* that the buyer pays the price in full to the seller (because in the absence of full payment by the buyer, it would be like selling a debt against a debt, which is prohibited). The things whose quality or quantity is not determined by specification cannot be sold through the contract of *Salam*. The exact date and place of delivery must be specified in the contract.
- ***Mudarabah*** (Profit Sharing): *Mudarabah* is an arrangement or agreement between the bank, or a capital provider, and an entrepreneur, whereby the entrepreneur can

mobilize the funds of the former for its business activity. The entrepreneur provides expertise, labor and management. In case of loss, the bank loses the capital, while the entrepreneur loses his provision of labor. The bank does not participate in the business and the profit is distributed according to the ratios fixed in the agreement between both parties. The financial loss is borne by the bank and the entrepreneur (manager) bears the loss by not getting any return in compensation for the opportunity cost of his own labour and managerial work.

- ***Musharakah*** (Joint Venture or Equity Participation): It is a relationship between two parties, both of whom contribute capital to a business, and divide the net profit and loss. This is often used in investment projects, letters of credit, and the purchase or real estate or property.. 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. Similar to *Mudarabah*, where the client buys ownership in the end.
- ***Hibah*** (Gift): This is a token given voluntarily by a creditor to a debtor in return for a loan.
- ***Musawamah***: *Musawamah* is a general and regular kind of sale in which price of the commodity to be traded is bargained between seller and the buyer without any reference to the price paid or cost incurred by the former. Unlike *Murabahah* the seller in *Musawamah* is not obliged to reveal his cost. Both the parties negotiate on the price. All other conditions relevant to *Murabahah* are valid for *Musawamah* as well.
- ***Qard Hassan*** (Good Loan): This is a loan extended on a goodwill basis, and the debtor is 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 (this is the case in which *Hibah* usually arises). 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, since it is the one type of loan that truly does not compensate the creditor for the time value of money.
- ***Takaful*** (Islamic Insurance): It 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. Conventional insurance involves the elements of uncertainty in the contract of insurance, gambling as the consequences of the presence of uncertainty and interest in the investment activities of the conventional insurance companies that contravene the rules of *Shari'ah*. It is generally accepted by Muslim jurists that the operation of conventional insurance does not conform to the rules and requirements of *Shari'ah*.
- ***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 a *hibah* (gift) as a form of appreciation for the use of funds by the bank. In this case, the bank compensates depositors for the time-value of their money (i.e. pays interest) but refers to it as a gift because it does not officially guarantee payment of the gift.
- ***Wakalah*** (Agency) This occurs when a person appoints a representative to undertake transactions on his/her behalf, similar to a power of attorney**.**
- ***Sukuk*** (Islamic Bonds): *Sukuk* is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of a *Shari'ah* compliant bond used to raise capital bond. Fixed-income, interest-bearing bonds are not permissible in Islam: hence, *Sukuk* is a security that complies with the Islamic law and its investment principles, which prohibit the charging or paying of interest. *Sukuk* is asset-based and tends to be used in conjunction with an *Ijarah* or *Musharakah* structure. Holding a *Sukuk* confers a beneficial interest to the holder - in terms of holding a proportional ownership of the underlying asset - as well as the income that it generates. The *Sukuk* holder also assumes all rights and obligations for the maintenance of the asset. In a conventional bond, the investor has no such beneficial interest nor rights and obligations and is only entitled to receiving interest.

- **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 currently exceed US$5 billion and is 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 fray or are thinking of launching similar Islamic equity products.

ISLAMIC FINANCE AND CSR

The increased interest in Islamic investing stems from the fact that there are 1.5 billion Muslims in the world and that Islamic investing is based on the principle of social investing. In fact, there is overlap between Islamic attitudes to wealth and ethics: for investment purposes Islamic financial institutions employ criteria similar to those used by the ethical investment funds. The big difference comes in the way they structure lending transactions, both for personal finance and business purposes. In simple terms, lenders enter into risk-sharing contracts with borrowers, so the return is based on the outcome of the venture or investment, rather than a predetermined rate. Besides, Islamic investment funds, just as most broadly screened SRI funds do, eschew alcohol, tobacco, pornography, gambling and arms. They also avoid, as we said before, companies that produce or market pork-related products, in keeping with the precepts of *Shari'ah*, as well as financial service companies charging interest. Some, but not all, cut out companies producing environmentally damaging products.

To sum up, the two major guiding principles of Islamic investing are: no interest and social responsibility. Islamic banks often describe themselves as being providers of ethical financial services, seeking to remove the element of greed and elitism inherent in credit-lending and fostering a system where entrepreneurship and credit are rewarded on the basis of profit and risk sharing.

More specifically, the essential concepts of Islamic Finance are:

- Transparency and clarity of rights and obligations;
- That income from securities must be related to the purpose for which the funding is used, and not simply comprise interest; and
- That securities should be backed by real underlying assets, rather than simply paper derivatives.

Socially responsible investment is a growing global phenomenon whereby investors select stocks based on the companies' moral and ethical behaviour. This typically includes avoiding involvement in certain businesses, as well as maintaining ethical environmental and employment practices. In Islam, these issues are governed by the *Shari'ah*.

Although some people may view this as restrictive, it in fact leads to investing in a company that is on sound financial and moral ground.

In addition to investing in stocks, the fund is also involved in giving to charity on behalf of its investors. This charity comes in the form of "purification" of investment gains. The fund manager, along with guidance from the advisory board must estimate the percentage of profits that may have come from *riba* and other prohibited activities and donate it to general charitable causes so that their investment and profit remain pure.

Without a doubt, social responsibility among companies is no longer a social aspect; rather, it has become an unwritten ethical code that companies must abide by and allocate a portion of their budget for. This approach aims to share the benefits with our societies, which would especially benefit the economies that do not impose taxes on companies, such as most of the economies in the Gulf States.

Society's predominant expectation from business in the MENA (Middle East and North Africa) region is to create employment. Manifestations of economic responsibility such as fair play, disclosure and transparency, and prudent governance are generally ignored by the society.

Philanthropy is the most common manifestation of corporations' social agenda in the MENA countries, but certainly not after and above fulfilment of other responsibilities. It can also be argued that given the poor performance of governments in the region, where corruption and unregistered economy are a major issue, business has no choice but step in to reduce the social tension, gain legitimacy and create a safer environment to conduct business.

The majority of Gulf companies devotes a share of their budgets to nurture the indigent part of the population or grant scholarship opportunities to those who excel academically and for medical and academic research, in addition to environmental awareness programs, among others. Other activities focus around building hospitals and schools etc, all of which fall under the responsibility of the state and are severely undersupplied.

One of the areas in which Islamic finance is just beginning to become involved is financing renewable energy projects. This area seems natural for financial system driven by ethics which promote forms of business that are socially beneficial, as well as profitable. The area of renewable energy, particularly with the growing concerns about climate change, is appropriate for Islamic finance given the view of man in Islam.

For many Muslims the key global political concern is the Palestinian quest for statehood. And with the failure of military and diplomatic efforts to put pressure on Israel, for some the focus has switched to economic pressure. Their targets are companies with links to Israel; many of these are based in the US, Israel's main sponsor. Accordingly, Starbucks, Coca-Cola, Pepsi-Cola and Burger King have all been targets of a divestment campaign in some Middle Eastern countries.

ISLAMIC FINANCE AND THE SUBPRIME CRISIS

Islamic banks have been largely shielded from the U.S. mortgage crisis. At the core of the current subprime crisis is the securitization of subprime mortgages or debts (a concept that would generally not be acceptable from a *Shari'ah* perspective, as well as are not compliant alternative instruments such as derivatives and most hedge fund strategies). This creates an economic problem which leads to bubbles and market falls: as interest increases the cost of an asset on the basis of credit, demand falls, if demand falls, then supply must also fall, if supply falls then productivity must fall as well which then results in unemployment, labour problems and disturbance to the financial market. There has been a lot of talk recently about the possibility of an international recession as major financial institutions have collapsed one after another and their experiences have not assisted in avoiding or predicting this crisis. What has happened so far might only be the tip of the iceberg.

Islam bans lending on interest and trading of debt. Scholars vet every stage of a transaction to ensure compliance with *Shari'ah* making it unlikely that risks were lurking in the balance sheets of unsuspecting lenders. Lenders in the Gulf and Malaysia, the global hubs of Islamic finance, have barely reported any subprime related losses.

The transparency and structure demanded of Islamic finance that is attracting investors burned by the subprime crisis could well have provided warning signals of the impending debt turmoil.

In fact, there's been an exodus from riskier asset classes, partly as investors veer away from sophisticated products like collateralized debt obligations. Investors say Islamic finance products demand greater transparency and accountability from company management that must avoid transactions that have an element of speculation and those that are not asset-based, thus providing investors with tangible safeguards, so it would be more obvious when companies are getting into debt problems. Besides, under Islamic finance, the lender is also an investor, so he remains an active participant through the life of the transaction and is in a position to rectify mistakes before the situation worsens.

These features provided early warnings to investors before such corporate debacles as the collapse of Enron and WorldCom. Both companies were part of the Dow Jones Islamic Market Index, created in 1999, which has a screening process under which constituents with unacceptable financial ratios are removed from the benchmark.

That happened to Enron and WorldCom: they were excluded from the DJ Islamic Market Index months before the crash, the high level of debt indicating ineffectiveness of control.

The Islamic equity fund industry is beginning to promote itself based on similarities with socially responsible investing. This is an overdue development because although many people, both Muslims and non-Muslims, understand how socially responsible investing works, many are unaware of how many similarities there are between socially responsible investing and *Shari'ah*-compliant investing. Both use negative screens to exclude companies operating in unethical industries and both exclude largely the same types of companies. The similarities are so great because both are looking at a double bottom line: creating profits and avoiding social harm. Islamic finance has potential to grow in popularity among non-Muslims who are looking to invest ethically.

This is what qualifies Islamic banking to solve a number of problems that the contemporary financial system suffers from as a result of using methods and tools that are purely governed by the selfish economic interests of humans irrespective of the catastrophic effects this may have on society.

In view of the fact that a number of Western societies have been hit by this crisis, where numerous Islamic banking institutes are based, many researchers within these societies will look into the foundations upon which these institutions are based and the methods that they follow and that have protected them from this financial storm.

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CONCLUSION

The Islamic banking sector is big. As of January, some 300 Islamic Financial Institutions (IFIs) operated in 75 countries, managing some $500 billion. The GCC has the largest concentration of IFIs due to the simple fact that the region is the primary source of funding for Islamic banking activity.

Furthermore, there is a growing demand for Islamic banking in non-Muslim countries. Established in 2004, the Islamic Bank of Britain (IBB) offers financial products compliant with *Shari'ah*. And it is suggested that the UK government is contemplating issuing *Sukuk*. France is seeking to get a share of Islamic finance on the back of its considerable Muslim community. Conventional banks in many western, as well as eastern, countries after realising the huge benefit of the Islamic banking system have opened Islamic banking windows that run parallel with interest-based windows. Very recently the Reserve Bank of India and Japan have shown their interest to offer Islamic banking system to their customers, not only for their respective countries, but also for customers from Muslim majority Middle Eastern countries, and the same is happening in the USA, Switzerland and China.

Nevertheless, Islamic banking must overcome certain challenges. These include developing short-term products to absorb demand and to help develop a secondary market. The second concern deals with ensuring the availability of *Shari'ah* scholars with knowledge of conventional and Islamic finance. The third matter deals with ensuring availability of qualified human resources meeting the requirements of an ever growing industry. It is believed that demand exceeds supply in all three cases. Another test deals with ensuring uniformity of application of accounting principles for Islamic banks.

The growing trend for Islamic finance is supported by demand from cash-rich investors in the Persian Gulf seeking new investment opportunities in their home region, which is witnessing an economic boom fueled by record revenues from three years of high oil prices. Islamic bankers, keeping pace with sophisticated techniques and latest developments have evolved investment instruments that are not only profitable but are also ethically motivated. With new investment opportunities opening up in the Gulf, significant volumes of money are flowing back to the region. This in turn is also driving demand for banking products and services compliant with Islamic law. New products and services are being made available by banks in the Gulf states and Muslim countries in Asia and are increasingly becoming rival offerings to conventional banks.

This growth has taken place amid the international political uncertainties in the Middle East region, the international markets crisis and the oil price race, proving to be much sounder than financial analysts might have predicted and assuring a future full of possibilities for the Islamic financial system.