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# Introduction to **Islamic** **banking** **and** **finance**

BRIAN KETTELL

# Introduction to Islamic Banking and Finance

**Brian Kettell**

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藏书章



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*To my wife Nadia, our son Alexei and daughter Anna.  
Nadia keeps the whole fleet on an even keel with only the  
occasional shipwreck.*

## Preface

When asked what Islamic banking is, a conventional banker is likely to mumble something about religion. He may then say, 'Well they cannot charge interest but they use something else which is the same thing'. This 'something else', incidentally, is never defined. The banker may then move on to describe Islamic banking as being about smoke and mirrors. To conclude he will then profoundly announce that, with a few tweaks, it is what he does every day anyway. And that is the end of it.

If pushed to actually describe an Islamic financial instrument or, even worse, to define some Islamic terminology such as *Murabaha* or *Mudaraba*, then the banker's eyes will start to gloss over.

Frankly this stereotyped image is all too prevalent within the banking world. In an endeavour to both enlighten conventional bankers and broaden the understanding of Islamic banking principles, this book highlights the key characteristics of Islamic banking that differentiate it from conventional banking.

As the reader will learn, Islamic banking is not about smoke and mirrors. It is in fact about banking based on Islamically-ethical principles which are, in many ways, very different indeed from conventional banking principles. So what exactly is Islamic banking all about?

The first modern experiment with Islamic banking was undertaken in Egypt without projecting an Islamic image for fear of being seen as a manifestation of Islamic fundamentalism that was anathema to the political regime. The pioneering effort, led by Ahmad Elnaggar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963. This experiment lasted until 1967.

Islamic banking is a banking system that is consistent with the *Sharia'a* (Islamic law) and, as such, an important part of the system is the prohibition on collecting *riba* (interest or usury). The *Sharia'a* also prohibits trading in financial risk because this is seen as a form of gambling, something forbidden in Islam. Another prohibition under the *Sharia'a* is that Muslims cannot invest in businesses that are considered *haram* (forbidden or sinful) such as those that sell alcohol, pork, engage in gambling or produce un-Islamic media.

The central religious precept driving the Islamic finance industry is the idea that *riba* is *haram*. At first glance, this appears to rule out most aspects of modern finance. But although the *Qur'an* bans the creation of money, by money, it does allow money to be used for trading tangible assets and businesses – which can then generate a profit.

Consequently Islamic financial products are designed to create trading or business arrangements that pay profits to investors (or lenders) from business transactions backed by tangible assets, ideally sharing risk and rewards.

Ironically, some of these structures and techniques echo those that flourished in Christendom in Europe between the 12th and 15th centuries. In AD 325, the Christian Council of Nicea banned the practice of usury among the clergy and in AD 1140 this principle was extended to church members.

When trade expanded in Europe from the 12th century onwards, however, merchants at trade fairs became adept at constructing financial transactions that avoided religious censure. Loans were sometimes considered to be rent charges, or interest payments were classified as *damnum emergens* (opportunity loss) or *lucrum cessans* (forgone income), which were permitted by the Church. Another popular scheme was the *contractus trinius*, a three-way partnership scheme. (Meanwhile, Jews were permitted to continue money-lending because Christians presumed that they were already excommunicated.) These practices eventually died out in the 16th century, when the Church loosened its ban on usury payments.

The structure of an Islamic bank is radically different from its conventional, Western, counterpart. A conventional bank is primarily a borrower of funds on the one hand and a lender on the other. An Islamic bank is rather a partner with its depositors, as well as with entrepreneurs, sharing profit or loss on both sides of the balance sheet.

Another distinction is that a conventional bank would not stop charging interest even if the deployment of its capital fails to bear profit for the entrepreneur, whereas an Islamic bank cannot claim profit if the outcome is a genuine loss.

Islamic banks have been operating in places such as Bahrain, Saudi Arabia, Malaysia and Dubai for some time. Conventional bankers have traditionally viewed the sector as a small, exotic niche, focused on household investors. But in the past ten years something extraordinary has occurred behind the scenes.

Many Western investment banks have increasingly started working with Muslim clerics to create a new range of financial products designed for devout Muslims. The new Islamic banking products range from simple savings schemes or mortgages, to the type of complex capital market products that large corporations and governments use to raise billions of dollars. Some devout Muslims view this trend with dismay, claiming it perverts the true spirit of their religion. However, many more welcome it.

Estimates of the size of the Islamic finance industry currently vary wildly from US\$800 billion to US\$950 billion. However, everyone agrees that the business is expanding rapidly. This is particularly true given the oil wealth of the Gulf states, which have fuelled demand for such financial services. Yet another factor contributing to this increased demand is the growing Muslim population in Europe and the United States.

The increased demand for Muslim financial institutions in the West has also prompted Western firms to begin providing these services. HSBC, Lloyds Bank, Deutsche Bank and Citigroup are among the most notable examples of Western firms adapting to tap these new funds. Appendix 2 lists out details of some 500 Islamic financial institutions.

**Companion texts are also available from the publishers: *The Islamic Banking and Finance Workbook and Case Studies in Islamic Banking and Finance*.**

**Note on the text**

Over the years, problems of transliteration have resulted in a variety of acceptable English spellings for Arabic terminology. For example, the Islamic holy scriptures can be spelt in English as *Koran*, *Qoran*, *Quran* and *Qur'an*. This book applies one convention consistently and so readers should have no problems following the text, but this issue is something to bear in mind when searching for information on the Internet.

## About the Author

**Brian Kettell** has a wealth of practical experience in the area of Islamic banking and finance. He worked for several years as an Advisor for the Central Bank of Bahrain where he had numerous Islamic banking responsibilities.

Subsequently, Brian taught courses on Islamic banking and finance at a range of financial institutions including the World Bank, National Commercial Bank (Saudi Arabia), Global Investment House (Kuwait), Noor Islamic Bank (UAE), the UK Treasury, the Central Bank of Iran, the Central Bank of Syria, the Chartered Institute for Securities and Investment, the Institute for Financial Services and Scotland Yard.

Brian's vast academic expertise in Islamic finance is highlighted by his role as former Joint Editor of the *Islamic Finance Qualification Handbook* and his past teaching work at a number of top universities worldwide including the London School of Economics, the City University of Hong Kong, the American University of the Middle East in Kuwait and London Metropolitan University Business School.

Brian's impressive list of publications include over 100 articles in journals, business magazines and the financial press including *Islamic Business and Finance*, *Islamic Banking and Finance*, the *Central Banking Journal*, *Euromoney*, the *Securities Journal* and the *International Currency Review*. He has also published 16 books on Islamic banking and financial markets.

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# Muslim Beliefs

Islam is the name of the religion transmitted by the Prophet Mohammed as revealed to him by God (Allah). Central to Islamic beliefs is The *Qur'an*, which can be defined as 'the book containing the speech of God revealed to the Prophet Mohammed in Arabic and transmitted to us by continuous testimony'. The *Qur'an* is deemed to be a proof of the prophecy of Mohammed, is the most authoritative guide for Muslims and is the first source of the *Sharia'a*. The *Ulema* (religious scholars) are unanimous on this point, and some even say that it is the only source and that all other sources are explanatory of the *Qur'an*. The salient attributes of the *Qur'an*, which are indicated in this definition, can be summarised in five points:

- It was revealed exclusively to the Prophet Mohammed.
- It was put into writing.
- It is all *mutawatir* (universally accurately reported).
- It is the inimitable speech of God.
- It is recited in *salah* (ritual prayer).

## 1.1 FIVE PILLARS OF FAITH

The structure of Islam is founded on pillars. Just as the strength and stability of any structure depends on the supporting pillars, the strength and stability of Islam depends on its pillars. Muslims are duty-bound to acquaint themselves with the nature of Islam's pillars.

During the 10 years between his arrival in Medina and his death in AD 632, Mohammed laid the foundation for the ideal Islamic state. A core of committed Muslims was established, and a community life was ordered according to the requirements of the new religion. In addition to general moral injunctions, the requirements of the religion came to include a number of institutions that continue to characterise Islamic religious practice today.

Foremost among these institutions are the five pillars of Islam. These are the essential religious duties required of every mentally able, adult Muslim. The five pillars are each described in some part of the *Qur'an* and were already being practised during Mohammed's lifetime. They are:

- the profession of faith (*Shahada*);
- daily prayer (*Salat*);
- almsgiving (*zakat*);
- fasting (*sawm*);
- pilgrimage (*hajj*).

Although some of these practices had precedents in Jewish, Christian and other Middle Eastern religious traditions, taken together they distinguish Islamic religious practices from