FREQUENTLY ASKED QUESTIONS IN ISLAMIC FINANCE

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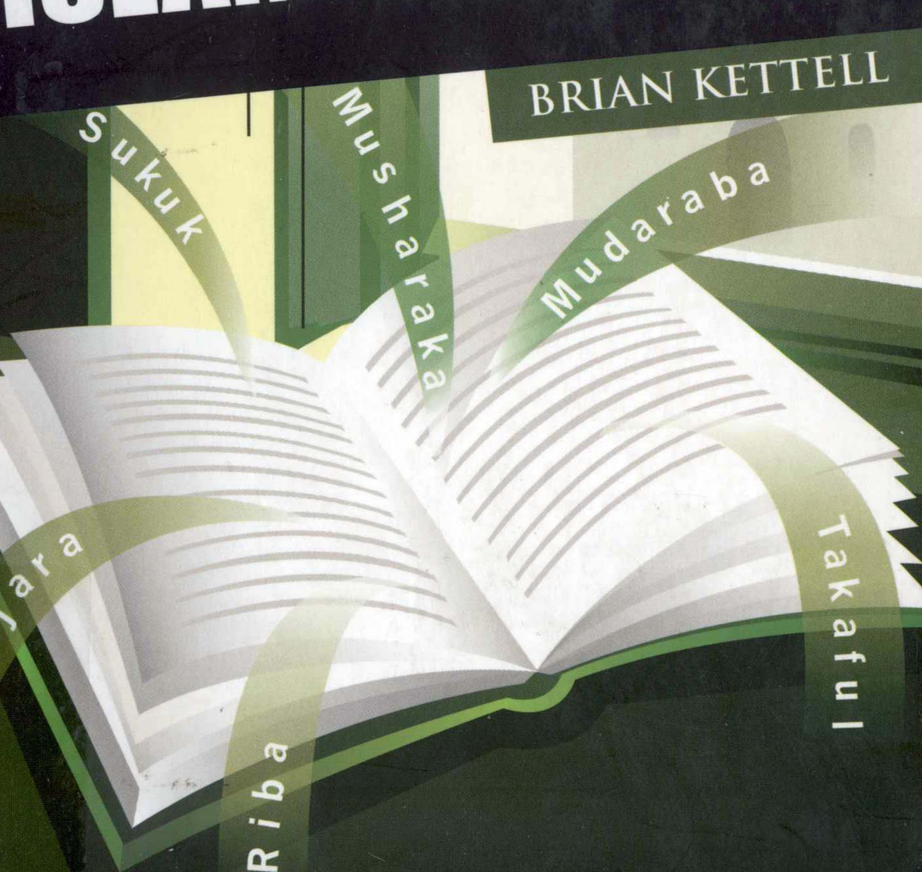

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Preface

The ongoing turbulence in the global financial markets has drawn attention to an alternative system of financial intermediation, Islamic banking and finance. This sector of the financial markets has so far remained on the sidelines of this turbulence. It is a sector which has undergone rapid growth in recent years. Despite this growth the financial community remains largely uninformed as to the key characteristics of the industry. But what exactly is Islamic banking and how does it work? This short text is designed to answer the frequently asked questions almost always raised, by non-specialists, whenever the subject of Islamic banking gets mentioned. It is literally FAQs. Readers seeking more specialised knowledge need to refer to some of my other publications listed earlier.

Even amongst conventional bankers there is much misunderstanding as to what Islamic banking is all about. If you ask a conventional banker what Islamic banking is, he will mumble something about religion. He will 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 will 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 describing 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 these FAQs attempt to answer some of the key issues involved which distinguish Islamic banking 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.

The earliest history of Islamic banking goes back to attempts by Muslim Brotherhood members in the early 1930s to establish Islamic banking in India, an experiment which failed. Egyptian President Gamal Abdel-Nasser shut down the second attempt in 1964, after only one year, later arresting and expelling the Muslim Brothers.

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 and paying interest (riba, in Arabic). 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 and 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 - that can then generate a profit.

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

The structure of an Islamic bank is radically different from its conventional 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 to have a right to 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.

Several Western investment banks have increasingly started working with Muslim clerics to create a new range of financial products designed for devout Muslims. Somewhat surprisingly, many argue, these have also been welcomed by non-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 that 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 $700 billion to $800 billion. However, whatever the numbers, everyone agrees that the business is expanding rapidly.

The increased demand for Muslim financial institutions in the West has, as mentioned, prompted Western firms to begin providing these services. HSBC, Lloyds Bank, Deutsche Bank, BNP and Citigroup are among the most notable examples of Western firms adapting to tap these new funds.

Introduction

What is Islamic Banking?

What Exactly Is Islamic Banking All About?

Islamic financial institutions are those that are based, in their objectives and operations, on Qur'anic principles. They are thus set apart from 'conventional' institutions, which have no such religious preoccupations. Islamic banks provide commercial services which comply with the religious injunctions of Islam. They provide services to their customers free of interest, (the Arabic term for which is *riba*), and the giving and taking of interest is prohibited in all transactions. This prohibition makes the Islamic banking system differ fundamentally from the conventional banking system.

Technically, *riba* refers to the addition in the amount of the principal of a loan according to the time for which it is loaned and the amount of the loan. In historical times, there was a fierce debate as to whether *riba* relates to interest or usury, although there now appears to be consensus of opinion among Islamic scholars that the term extends to all forms of interest.

The term *riba*, in Islamic law (the *Sharia'a*), means an addition, however slight, over and above the principal. According to the Federal *Sharia'a* Court of Pakistan, this means that the concept covers both usury and interest; that it applies to all forms of interest, whether large or small, simple or compound, doubled or redoubled; and that the Islamic injunction is not only against exorbitant or excessive interest but also against even a minimal rate of interest. Financial systems based on Islamic tenets are therefore dedicated to the elimination of the payment and receipt of interest in all forms. It is this taboo that makes Islamic banks and other financial institutions different, in principle, from their Western conventional counterparts.

There are a range of modern interpretations of why *riba* is considered *haram* (forbidden) but these are strictly secondary to the religious underpinnings.

The fundamental sources of Islam are the Holy Qur'an and the *Sunnah*, a term which in Ancient Arabia meant 'ancestral precedent' or the 'custom of the tribe', but which is now synonymous with the teachings and traditions of the Prophet Mohammed as transmitted by the relaters of authentic tradition (*hadith*). Both of these sources treat interest as an act of exploitation and injustice and, as such, it is inconsistent with Islamic notions of fairness and property rights. While it is often claimed that there is more to Islamic banking than this, such as its contribution towards economic development and a more equitable distribution of income and wealth, its increased equity participation in the economy, and so on, Islamic banking, nevertheless derives its specific *raison d'être* from the fact that there is no place for the institution of interest in the Islamic order.

This rejection of interest poses the central question of what replaces the interest rate mechanism in an Islamic framework. Financial intermediation is at the heart of modern financial systems. If the paying and receiving of interest is prohibited, how do Islamic banks operate? Here, profit and loss sharing (PLS) comes in, substituting for interest as a method of resource allocation and financial intermediation.

The basic idea underlying Islamic banking can be stated simply. The operations of Islamic financial institutions primarily are based on a PLS principle. An Islamic bank does not charge interest but rather participates in the yield resulting from the use of funds. The depositors also share the profits of the bank according to a predetermined ratio. There is thus a partnership between the Islamic bank and its depositors on one side, and the bank and its investment clients on the other side as a manager of depositors' resources in productive uses. This is in contrast with a conventional bank, which mainly borrows funds paying interest on one side of the balance sheet and lends funds, charging interest, on the other. The complexity of Islamic banking comes from the variety (and nomenclature) of the instruments employed, and in understanding the underpinnings of Islamic law.

Six key principles drive the activities of Islamic banks:

1. predetermined loan repayments as interest *(riba)* is prohibited;
2. PLS is at the heart of the Islamic system;
3. making money out of money is unacceptable. All financial transactions must be asset-backed;
4. speculative behaviour is prohibited;
5. only *Sharia'a* approved contracts are acceptable;
6. the sanctity of contracts.

These principles, as applied to Islamic banking and finance, are set out below.

1. Predetermined payments are prohibited

Any predetermined payment over and above the actual amount of principal is prohibited. Islam allows only one kind of loan and that is *qard al hassan* (literally 'good loan') whereby the lender does not charge any interest or additional amount over the money lent. Traditional Muslim jurists have construed this principle so strictly that, according to one Islamic scholar, 'the prohibition applies to any advantage or benefits that the lender might secure out of the *qard* (loan) such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall'. The principle derived from the quotation emphasises that any associated or indirect benefits which could potentially accrue to the lender are also prohibited.

2. Profit and loss sharing

The principle here is that the lender must share the profits or losses arising out of the enterprise for which the money was lent. Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business, instead of becoming creditors. Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether these are manufacturing industries, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures.

This is unlike the interest-based commercial banking system, where all the pressure is on the borrower: he must pay back his loan, with the agreed interest, regardless of the success or failure of his venture.

The principle, which thereby emerges, is to try and ensure that investments are made into productive enterprises. Islam encourages these types of investments in order that the community may ultimately benefit. However, Islam is not willing to allow a loophole to exist for those who do not wish to invest and take risks but are rather intent on hoarding money or depositing money in a bank in return for receiving interest (*riba*) on these funds for no risk (other than the bank becoming insolvent).

Accordingly, under Islam, either people invest with risk or suffer loss by keeping their money idle. Islam encourages the notion of higher risks and higher returns and promotes it by leaving no other avenue available to investors, the objective here being that high-risk investments provide a stimulus to the economy and encourages entrepreneurs to maximise their efforts to make them succeed, with appropriate benefits to the community.

Risk-sharing

As mentioned above, one of the most important features of Islamic banking is that it promotes risk-sharing between the providers of funds (investors) and the user of funds (entrepreneurs). By contrast, under conventional banking, the investor is assured of a predetermined rate of interest.

In conventional banking, all the risk is borne by the entrepreneur. Whether the project succeeds and produces a profit or fails and produces a loss, the owner of capital is still rewarded with a predetermined return. In Islam, this kind of unjust distribution is not allowed. In pure Islamic banking, both the investor and the entrepreneur share the results of the project in an equitable way. In the case of profit, both share this in pre-agreed proportions. In the case of loss, all financial loss is borne by the capital supplier with the entrepreneur being penalised by receiving no return (wages or salary) for his endeavours.

Emphasis on productivity as compared to credit-worthiness

Under conventional banking, almost all that matters to a bank is that its loan and the interest thereon are paid on time. Therefore, in granting loans, the dominant consideration is the credit-worthiness of the borrower. Under PLS banking, the bank will receive a return only if the project succeeds and produces a profit. Therefore, it is reasoned, an Islamic bank will be more concerned with the soundness of the project and the business acumen and managerial competence of the entrepreneur.

3. Making money out of money is not acceptable

Making money from money is not Islamically acceptable. Money, in Islam, is only a medium of exchange, a way of defining the value of a thing. It has no value in itself, and therefore should not be allowed to generate more money, via fixed interest payments, simply by being put in a bank or lent to someone else.

The human effort, initiative and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital rather than capital, meaning that money becomes capital only when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not as a capital and, as such, it is not entitled to any return (i.e. interest).

Muslims are encouraged to spend and/or invest in productive investments and are discouraged from keeping money idle. Hoarding money is regarded as being Islamically unacceptable. In Islam, money represents purchasing power, which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.

4. Uncertainty is prohibited

Gharar (uncertainty, risk or speculation) is also prohibited.

Under this prohibition, any transaction entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values (goods received and/or prices paid) intended to be exchanged as a result of their transactions. Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains' which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount designed to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as un-Islamic and so are forward foreign exchange transactions, given that forward exchange rates are determined by interest rate differentials.

5. Only Sharia'a approved contracts are acceptable

Conventional banking is secular in its orientation. In contrast, in the Islamic system, all economic agents have to work within the moral value system of Islam. Islamic banks are no exception. As such, they cannot finance any project which conflicts with the moral value system of Islam. For example, Islamic banks are not allowed to finance a distillery, a casino, a night club or any other activity which is prohibited by Islam or is *known* to be harmful to society.

6. Sanctity of contracts

Many verses in the Holy Qur'an encourage trade and commerce, and the attitude of Islam is that there should be no impediment to honest and legitimate trade and business. It is a duty for Muslims to earn a living, support their families and give charity to those less fortunate.

Just as Islam regulates and influences all other spheres of life, so it governs the conduct of business and commerce. Muslims have a moral obligation to conduct their business activities in accordance with the requirements of their religion. They should be fair, honest and just towards others. A special obligation exists upon vendors as there is no doctrine of *caveat emptor* in Islam. Monopolies and price-fixing are prohibited.

The basic principles of commercial *Sharia'a* law are laid down in the four root transactions of:

1. sales (*bay*), transfer of the ownership or corpus of property for a consideration;
2. hire (*Ijara*), transfer of the usufruct (right to use) of property for a consideration;
3. gift (*hiba*), gratuitous transfer of the corpus of property; and
4. loan (*ariyah*), gratuitous transfer of the usufruct of property.

These basic principles are then applied to the various specific transactions of, for example, pledge, deposit, guarantee, agency, assignment, land tenancy, *waqf* foundations (religious or charitable bodies) and partnerships.

Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. This is potentially a major problem for Islamic banks, and is discussed below.

What Is Asymmetric Information?

This can be defined as information that is known to one party in a transaction but not to the other.

The classical issue here is that some sellers with inside information about the quality of an asset will be unwilling to accept the terms offered by a less informed buyer. This may cause the market to break down, or at least force the sale of an asset at a price lower than it would command if all buyers and sellers had full information. This is known as the 'lemon market' problem in valuation. A lemon, in this context, refers to a poor-quality asset.

This concept has been applied to both equity and debt finance.

For equity finance, shareholders demand a premium to purchase shares of relatively good firms to offset the losses arising from funding lemons. This premium raises the cost of new equity finance faced by managers of relatively high-quality firms above the opportunity cost of internal finance faced by existing shareholders.

In the debt market, a borrower who takes out a loan usually has better information about the potential returns and risk associated with the investment projects for which the funds are earmarked. The lender on the other side does not have as much information concerning the borrowers as he would like.

Lack of enough information creates problems before and after the transaction is entered into. This is potentially a major problem with Islamic profit-sharing financial contracts.The presence of asymmetric information normally leads to adverse selection and moral hazard problems.

Information asymmetry comes in two versions:

1. Adverse selection

This refers to a situation in which sellers have relevant information that buyers lack (or vice versa) about some aspects of product quality. This is the problem created by asymmetric information before the transaction occurs. It occurs when the potential borrowers who are the most likely to produce an undesirable (adverse) outcome. Bad credit risks are those who most actively seek out a loan and are thus most likely to be selected. Again, this is potentially a problem with Islamic profit-sharing financial contracts.

In the simplest case, lenders cannot price discriminate (i.e. vary interest rates) between good and bad borrowers in loan contracts because the riskiness of projects is unobservable. Thus, when interest rates increase, relatively good borrowers drop out of the market, increasing the probability of default and possibly decreasing lenders' expected profits. In equilibrium, lenders may set an interest rate that leaves an excess demand for loans. Some borrowers receive loans, while other, observationally equivalent borrowers, are rationed.

2. Moral hazard

Moral hazard is the consequence of asymmetric information after the transaction occurs. The lender runs the risk that the borrower will engage in activities, described below, that are undesirable from the lender's point of view because they make it less likely that the loan will be paid back.

The conventional debt contract is a contractual agreement by the borrower to pay the lender a fixed amount of money at periodic intervals. When the firm has high profits, the lender receives the contractual payments and the lender does not need to know the exact profits of the borrower. If the managers are pursuing activities that do not increase the profitability of the firm, the lender does not care as long as the activities do not interfere with the ability of the firm to make its debt payments on time. Only when the firm cannot meet its debt payments, thereby being in a state of default, is there a need for the lender to verify the state of the firm's profits.