Islamic Finance as an opportunity
Some Introductory notes to
Islamic Finance
• Agenda

- Short historical remarks
- Islamic economy and the Shari’ah
- Main features of Islamic Finance:
  - Riba
  - Gharar
  - Profit and Loss sharing schemes
• Agenda

- Islamic financial instruments:
  - Murabahah
  - Musharakah
  - Musharakah mutanaqisah
  - Ijarah with diminishing mushararakah
  - Islamic mutual funds
  - Sukuk

- Legitimacy of financial instruments: the Shari’ah board
- FAQ about Islamic finance
• Historical remarks:

Islamic finance and the Law

- We address Islamic investments, whose fundamentals derive from the Islamic law, called Shari’ah, which constitutes a part of every Muslim’s cultural and spiritual identity.

- Shari’ah is based largely on:
  - The Qur’an (the holy book of Muslims)
  - The Sunnah (the practices of the Prophet Muhammad)

These laws’ are to be followed in letter and spirit and cannot be violated or ignored on the basis of one’s rational arguments or inner desires’ (Usmani, 2002)
• Historical remarks:

Shari’ah

- Shari’ah, means law and represents the rules that help the faithful to transform the faith and beliefs into daily practices.

- Quran and Sunnah are the primary sources of Shari’ah but Ijtihad (interpretation) plays a critical role.

- There are four main schools of law in the Sunni tradition:
  - The Hanafi school
  - The Maliki school
  - The Shafi’ school
  - The Hanbali school
• Historical remarks:

Shari’ah (2)

- Differently from other religions, Islam is not confined to moral teaching.

- The Qur’an, indeed, does not contain only moral teachings but offers guidance in all aspects of life, including any socioeconomic behavior.

- Religion is, thus, a fusion of life’s temporal and spiritual aspects.

- Islam differs from the other two major monotheistic religions – Christianity and Judaism – by its lack of division between religion and state (Baldwin, 1990)
Historical remarks:

The connection between the religious and the socio economic aspects of life derives from the biography of Muhammad, the Prophet of Islam.

- Muhammad was born in 570 AD (approx.), as a member of the Quraysh tribe.
- Due to his predication the clan members tried to ban him from the community.
- In 617 AD his wife, Khadija and his uncle, Abu Talib died.
Islamic economy and the Shari’ah

Shari’ah as a base for the Islamic economy

- The Shari’ah is composed of two parts:
  I. Shari’ah ‘ibadat: worship and rules of behavior (Five pillars of Islam)
  II. Shari’ah mu’amalat that constitutes the base for the Islamic economy

- Shari’ah rules and principles require that an Islamic financial transaction be supported by an underlying economic activity. There must be a strict link between financial and productive flows.
Islamic economy and the Shari’ah

Islamic economy

- Islamic economy does not dent profit, private ownership, or market forces, but they are not allowed in total freedom and must be observed in accordance with divine prescription.

- In this context, money in only a mean of exchange:
  - It cannot be used as an asset
  - May not generate a profit
  - At the same time, it cannot be left unproductive, since hoarding is not allowed under Shari’ah.
Main features of Islamic Finance

- The main features of Islamic finance derives from Shari’ah mu’amalat:
  - Prohibition of *Riba*
  - Prohibition of *Gharar*
  - Suggestion of the profit and loss sharing schemes as the only way to earn legitimate money.

- Islamic finance: a prohibition-driven finance?

All the prohibitions combined have the ultimate and cumulative effect of preserving balance, distributive justice, equal opportunity and must always be honored in any Islamic transaction.
Main features of Islamic Finance

RIBA

- The term comes from the verb “raba” that means “raise”, “increase” and gives birth to “riba”.

- Riba was prohibited during Mohammed times.

- Riba is commonly translated with “usury”, “interest”, “premium”.

- RIBA is quoted in just four sura of the Holy Quran and the verse concerning the prohibition (2:275-281, 3:130-2, 4:161 and 30:39) do not distinguish between exorbitant or a reasonable rate of interest.
• Main features of Islamic Finance

RIBA (2)

- The Quran is very severe with *riba*: it is considered as leading to restless curse and madness.
- Every faithful Muslim knows that *riba* is not permitted; the problem is, thought, to define exactly what “*riba*” means in modern times. Is just “interest” or “usury” or any increase on the capital loaned?
- Charging interest on money loaned (*riba*), regardless of the rate imposed, is explicitly prohibited.
Main features of Islamic Finance

RIBA (3)

- *Riba* encompasses every form of exploitation in business conduct and the concept is not restricted to charging interest but also applies, for instance, to the promise of remuneration with a predefined rate of return.

- Many economists agree in the following formal definition of *riba*:
  - It is a “premium” fixed ex-ante
  - It is tied to the time period and the amount of loan
  - Its payment is guaranteed regardless of the outcomes or the purposes for which the principal was borrowed.

- Economic rationale of *riba*. 
After *riba*, *gharar* is the most important element in financial contracts. It stems from informational problems and refers to any uncertainty created by the lack of information or control in a contract.

Any sort of ambiguity in contracting (i.e. uncertainty as to the quantity, quality, deliverability, or existence of the assets) is referred to as *gharar*.

*Gharar* can be thought as of ignorance in regard to an essential element in a transaction. *Gharar* makes a contract null and void.
Main features of Islamic Finance

The PLS schemes

- In the Quran it is stated that “Allah has permitted trade but has forbidden *riba*”.  
- It is reported an *hadith* of the Prophet stating: “*profit comes with liabilities*” (in Arabic “*al-kharaj bil dhaman and al-ghunm bil ghurm*”)  
- All Islamic legitimate financial instruments for trade and production purposes are based on risk-and-profit sharing as a return for the entrepreneurial effort and on financial capital.
• Main features of Islamic Finance

The building blocks

- Islamic financial forms are derived from the classical sources of Islamic jurisprudence.

- We have a number of classical contract which can verily combined to built more complex forms of instruments.

- The basic contracts are referred to as “building blocks”
• Main features of Islamic Finance

The building blocks (2)

Contracts / Instruments

Transactional Contracts
- Bay ‘ (Sale)
- Sart (Exchange)
- Sale of rights to use (Ijarah istisna)

Financing Contracts
- Trade Financing (Murabahah)
- Asset Backed (Ijarah Istitna)
- Equity Partnership (Musharakah)

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Intermediation Contracts
- Partnership
  - Mudarabah
  - Musharakah

Fee-Based Services
- Guarantee (kifala)
- Fee-Based Services (jo‘ala)
- Custody (Amanah)
- Representation (Wikala)

Insurance Takaful
- Gratuitos Loans (Quard-e-Hasna)
- Trust (Waqf)

Social Welfare Contracts
- Partnership
  - Mudarabah
  - Musharakah

Fee-Based Services
- Guarantee (kifala)
- Fee-Based Services (jo‘ala)
- Custody (Amanah)
- Representation (Wikala)

18
• Islamic financial instruments

MURABAHAH

- The *Murabahah* is a sale of goods with an agreed profit mark-up on the cost

1) Spot *murabahah*: the Islamic bank purchases the goods and makes them available for sale without any prior promise from a customer to purchase it.

2) *Murabahah* to the purchase orderer (AAOIFI): it is the sale of an item by the Institution to a customer (the purchase order) for a pre-agreed selling price, which includes a pre-agreed profit mark-up over its cost price, this have been specified in the customer’s promise to purchase. This kind of *murabahah* generally involves the deferred payments terms.
• Islamic financial instruments

MURABAHAH (2)

1) Promise to buy at Cost-Plus-Profit

2) The bank purchases the item on behalf of the client and stipulate a murabahah with the client indicating the profit (mark-up) and other details. Then the bank accepts the assets as collateral against the credit risk of the client.
• Islamic financial instruments

MURABAHAH (3)

➢ *Murabahah* to the purchase orderer has been used in UK to allow Muslims to buy their house using compliant instruments. The customer pays the sale price for the goods over instalments, effectively obtaining credit without paying interest.

➢ Regulatory bodies has eliminated the double stamp duty (the taxes to be paid on the purchase), on *murabahah* transaction.

➢ The Islamic Bank of Britain, i.e., established in August 2004 and based in Birmingham, offers a wide range of products, including savings accounts, term deposits, personal finance, home mortgages and business banking.
• Islamic financial instruments

MUSHARAKAH

➢ The *Musharakah* is the Islamic classic contract used to create a partnership.

➢ In the form of a *musharakah* with a financial institution, each party contributes to the partnership capital in equal or varying degrees to establish a new project or to share an existing one (*Accounting and Auditing Organization for Islamic Financial Institutions* AAOIFI definition).

➢ Each of the parties become an owner of the capital on a permanent basis and shall have his due share of profits.

➢ Losses are shared in proportion to the contributed capital.
MUSHARAKAH MUTANAAQISAH

- Musharakah can assume the form of diminishing musharaka (musharakah mutanaqisah).
- In this case the quote of ownership changes through the time. One of the parties becomes owner on a declining basis while the other on a increasing basis.
- It can be used for the financing of any activity allowed or to buy a good paying it through instalments.
• Islamic financial instruments

MUSHARAKAH MUTANAAQISAH (2)

- Example: Mr. Ali Hanif wants to purchase a boat to offer transport services in the Dubai Marina. He needs 200,000 AED (Dirhams) but he is short of funds and have only 40,000 AED.

- The Dubai bank enters a diminishing musharakah with Mr. Ali, agreeing to finance the purchase with 160,000 AED (80% of the share).

- The transport service provides a net income of 4,000 AED each month. The sum is shared according to the percentage owned:
  - Mr. Ali will retain 800 AED (20%)
  - The Dubai Bank will earn the remaining 3,200 AED (80%).

- At the same time, the Bank’s share is divided into 8 units, each worth 20,000 AED and it is agreed that Mr. Ali will buy, with a predetermined time schedule, one unit at a time.
• Islamic financial instruments

**MUSHARAKAH MUTANAQISAH (3)**

- As soon as Mr Ali will purchase the unit, he will be owner of the 30% of the boat and then he will be titled to earn the 30% of the monthly profit.
- Consequently, the bank will reduce its participation from 80% to 70%.
- The process will go on until the whole boat will be owned by Mr. Ali.

Results → Mr Ali will be financed
- the bank will receives its legitimate
- the transaction will receive be assets backed then it will be compliant
IJARA WITH DIMINISHING MUSHARAKAH

- *Ijarah* is the transfer of ownership of a service for a specific period for an agreed rent (leasing).

- The principle of *Ijarah with diminishing Musharakah* can be used for home buying services. Diminishing *Musharakah* means that the bank reduces its equity in an asset with any additional capital payment the client makes, over and above his rental payments. The client’s ownership in the asset increases and the bank’s stake decreases by a similar amount each time the client makes an additional capital payment. Ultimately, the bank transfers ownership of the asset entirely to the client.
• Islamic financial instruments

**ISLAMIC MUTUAL FUNDS**

- Due to difficulties in complying with religious prescription, Islamic financial markets have been characterized for a long time by the use of very basic financial instruments.

- Beginning in the 1980s, however, to serve the more sophisticated financial needs of high net worth individuals living in the Gulf area, the most prominent Islamic institutions started to widen their range of financial instruments. Islamic asset management funds were born in this period.

- Although still in their infancy, these managed funds have the potential to play a pivotal role in financial markets, since Muslims constitute about 20% of the world population.
• Islamic financial instruments

ISLAMIC MUTUAL FUNDS (2)

- Investors entering Shari’ah-compliant investments, particularly Islamic Mutual Funds, are increasing by about 12-15% per year, and the global Islamic fund management industry reached total assets under management of $66 billion with a forecast to reach 77 billion in 2029 (Thomson Reuters – may 2015).

- The major players in the asset management of Islamic investments are, among others, primary Western Investments Houses, such UBS, Schroders, HSBC and Deutsche Bank, that are trying to attract Muslim retail investors.
Before detailing the Islamic equity investment process and the filters used, it is important to acknowledge that, to be valid under Shari’ah, investments must abide by two basic conditions:

1. First, no fixed return can be promised or obtained, that is, the profit must be strictly linked to the performance of the companies whose stocks are in the portfolios;

2. The second binding condition refers to the inclusion of Shari’ah-compliant securities in the portfolios.
Ideally, we can split the Islamic equity investment process into three distinct phases, all ruled by religious prescription:

1. Portfolio asset allocation;
2. Instruments and trading strategies;
3. Income distribution and purification.
• Islamic Finance instruments

ISLAMIC MUTUAL FUNDS (5)

➢ In Portfolio asset allocation, the starting menu of stocks is to be screened according to religious prescription.

☐ The industry screens relate to the main activity of a company and its revenue allocation. I.e. all banks and insurance companies whose activities are interest based are screened out, as well as all companies involved in alcohol, tobacco, armaments manufacturing and trading, and the entertainment business.

☐ Second, even when they belong to legitimate sectors, companies are examined on the basis of their revenue allocation. If a company has business activities, for example, in breweries, defense, or pork related products, it is considered inappropriate for Islamic investment purposes and must be excluded from the portfolio.

☐ After these industry filters are applied, all remaining stocks are analyzed on the basis of financial ratio screens related to debt, interest-bearing securities, receivables and cash.
• Islamic financial instruments

**ISLAMIC MUTUAL FUNDS (6)**

- **Instruments and trading strategies**: once it is decided which companies can be included in the portfolio, the fund manager must comply with the rules related to the portfolio management activity.

- Some practices associated with stock trading are not permitted, such as short selling and margin trading.

- Some instruments, such as preferred stocks and interest-based bonds, are forbidden.

- Dealing in foreign exchange is strictly prohibited.

- The use of derivatives, as well, faces severe restrictions, since forward contracts, standard future contracts on commodities and on stock indices, are not permitted. Options are deemed permissible only in some cases.
• Islamic financial instruments

ISLAMIC MUTUAL FUNDS (7)

- **Income distribution and purification** is typical of Shari’ah-compliant investment.

- When included in portfolios, partially interest-contaminated balance figures are to be cleansed or purified.

- Once managers identify what is not acceptable from a Shari’ah point of view, they should deduct from the returns the prohibited part of the earning.
• Islamic financial instruments

SUKUK

- The word sukuk is the plural of the Arabic word Sakk, meaning certificate and reflects participation rights in the underlying assets.

- Sukuk were born to develop and launch a Shari’ah compatible bond-like security. The first attempt was done in Jordan in 1978.

- It is not a pure debt security since interest is prohibited in Islam but an obligation that is linked to the performance of a real asset in acceptable.

- The design of a sukuk is very similar to the process of securitization in conventional markets where were a wide range of asset types are securitized.

- Sukuk are participation certificates against a single asset or a pool of assets.
The Shari’ah Boards

- Islamic financial forms are derived from the classical sources of Islamic jurisprudence; the strict compliance to the sources justify the attribution of an “Islamic” label.
- Shari’ah board “certifies” this label. It is formed by a number of esteemed Shari’ah scholars skilled both in legal and economics issues.
- Problems with Shari’ah boards; a shortage of scholars can lead to conflict of interest because they can introduce a bias in the competition.
• Legitimacy of financial instruments

- Shari'a compliant funds must appoint at least three Shari'a scholars to the Shari'a Board according to AAOIFI standards.
- The scholars are responsible for issuing Fatwas related to the permissibility of the fund structure and investments.

- Screening must be performed to ensure compliance with Shari'a.
- The first level of screening removes any companies involved in non-Shari'a compliant industries and businesses.
- The second level of screening involves removing companies with financial ratios exceeding the acceptable levels.

- Conducting regular Shari'a audits for the fund is crucial to ensure compliance with Shari'a.
- The Shari'a audit can be performed by the Shari'a board or an external third party.

- The custodian does not have to be an Islamic institution but must adhere to Shari'a principles.
- The administrator must prepare fund accounts in accordance with AAOIFI standards.

- Non-Shari'a compliant income must be "purified".
- Shari'a board input is essential in determining the type of income to be purified.
- Purification is through donation to charitable institutions.

- In case of a failed trade, interest cannot be charged.
- An alternative approach such as the imposition of a fee may be allowed.

- Appointment of a Shari'a Board
- The Purification of Income
- Failed Trade
- Custody of Assets
- Shari'a Compliant Investment
- Shari'a Audit

Key Differences
• FAQ

➤ Is Islamic Finance a niche investments?

➤ Is Islamic Finance a charitable finance?

➤ Is Islamic Finance just a make-up?

➤ Is Islamic Finance just for Muslism?
FAQ

Is Islamic Finance a niche investments?

According to recent data by Thomson Reuters (2015), Islamic Finance investments in the world more then 1 trillion USD. An important part of them are invested in the mutual fund industry.
FAQ

- Is Islamic Finance a charitable finance?

To be interest free does not mean to be charitable since the seek for profit is as important as in the conventional finance. There are many ways to act in a charitable way, such as *qard hasan* (free loan), or *zakat* (compulsory alms).
FAQ

Is Islamic Finance just a make-up?

No, because financial instruments are designed to avoid *riba*, *gharar* and to ensure an asset backed economy. Financial contracts frameworks are very ancient and are backed by a comprehensive set of principles and rules.
FAQ

- Is Islamic Finance just for Muslims?

   No, because the idea of including ethics into investments is not just for Muslims. Exclusion criteria referred to firearms, pornography, alcohol, tobacco are shared by many value based investments such as SRI or religious investments.
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