

# Islamic Finance

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# Understanding Islamic Finance (1)

- Size: \$750 billion in assets
- Islamic products available in over 80 countries
- Growth rates in the past two decade: 12 to 26% a year
- Factors in future growth
- Demand side
- Supply side

# Understanding Islamic Finance (2)

- Common (Mis)perceptions
- Between Theory and Reality
- Institutional and Historical Realities
- A Rapidly Changing Field
- Religious, Political, Economic, Social, Regulatory and Demographic Factors
- Dangers of Binary Thinking

# Islam and the Shariah

- The pyramid structure of religious doctrine
- The Koran
- Hadith and Sunna
- Ijmah, qiyas, ijtihad
- Shariah as Divine Law

# The Question of Religious Interpretation

- Disagreements over the lower components of the pyramid
- External influences, idiosyncratic evolutions and doctrinal differences
- The first schisms (657, 661) and the fragmentation of the Umma

# Islamic Jurisprudence or Fiqh

- Sunni and Shia Traditions
- Main Sunni Schools:
  - Hanafi
  - Shafii
  - Maliki
  - Hanbali

# Adaptive Mechanisms

- Diversity, durability and adaptability
- The continuum of injunctions: obligatory, meritorious, morally neutral, reprehensible, forbidden
- Dispensations and exceptions
- 'urf (custom), maslaha (public interest) and darura (necessity)

# Examples of Adaptation

- Umeyyad and Abbasid Empires and the Attitudes towards Pre-existing Customs and Laws
- The 19<sup>th</sup> Century Encounter with the West and Islamic Modernists
- Compromises of the Islamic Revolution in Iran

# Islam and Money

- Islam born in the trading city of Mecca
- Prophet Mohammed was a merchant, as were most of the early caliphs
- Positive view of money and wealth if lawfully acquired; religious obligation of zakat
- Role of merchants in Islamicization of sub-Saharan Africa and parts of Asia

# The Question of Riba

- Range of Views
- Controversies Around Riba:
  - Any “increase”?
  - Any “fixed, pre-determined” return?
  - Distinction between “interest” and “usury”?
  - Introducing historical and economic factors
  - Relevance of adaptive mechanisms
  - Riba in the absence of an Islamic system

# The Question of Gharar (1)

- Gharar in the Koran and Hadith
- Maysir and games of chance
- Gharar means deception or delusion, and connotes peril, risk, hazard
- Ambiguity and lack of clarity
- Aleatory transactions; buying and selling of risk

# The Question of Gharar (2)

- Islam and Risk
- Modern derivatives and risk management instruments
- Risk sharing vs. risk transferring
- Deceptive ambiguity, Asymmetrical information,

# Zakat (1)

- The Meaning of Zakat
- Zakat or Almsgiving: one of the five pillars of Islam
- Zakat in Traditional Islam: the central feature of the welfare system
- Zakat as Income Redistribution
- Proper Recipients of Zakat: the poor and the needy, zakat collectors, travelers in difficulty, captives.
- Elaborate Rules: amounts, collection practices, exemptions, etc.

# Zakat (2)

- The Voluntary and Obligatory Paradox
- Elaborate and Evolutionary Rules Based on Revenues and Welfare Needs of Communities: amounts, collection practices, exemptions, etc.
- Zakat and Sadaqa
- Simplifying Zakat: the 2.5% Rule

# Zakat (3)

- Zakat in a Contemporary Setting
- Islamic Banks and Zakat:
  - Contributions to charity
  - Zakat administration and distribution
  - Qard Hassan
- Islamic Charities after September 11

# Commerce and Contracts in Islam (1)

- Islamic View of Commerce and Wealth
- Centrality of Contracts and Consent
- Protection of the Weaker Party; Premium on Simplicity and Clarity
- Restrictions on *Shurut* (stipulations)
- Condemnation of promise-breaking

# Commerce and Contracts in Islam (2)

- Certain Hadiths raise objections to certain free contracts:
  - “(The Prophet) forbade a sale and a stipulation (*bay’ wa-shart*).
  - The Messenger of God forbade two bargains (*safqah*) in one.
  - The Prophet forbade sale of the delayed obligation for a delayed obligation.

# Commerce and Contracts in Islam

## (3)

- Prohibition of the sale or exchange of debt

# Commercial Ethics: The Moral Economy of Islam

- Literalism vs. the spirit of Islam
- Ethical principles: fairness; honesty, productivity, prohibition of hoarding wealth or conspicuous consumption; contribution to welfare
- Profit from trade vs. profit from riba

# General Principles of Islamic Finance

- Asset-based finance
- The returns belong to the one bearing the risk: Profits belong to the one taking the risk; any benefits derived from a transaction must be accompanied with the liability arising from potential loss.
- Time value of money is accepted, but in connection with the risk involved

# Traditional Financial Instruments

- A World of “Bankers Without Banks”
- Al Wadiah
- Qard Hassan
- Profit-and-Loss Sharing

# The Ideal of Modern Islamic Finance

The ideal from a micro perspective: Profit and loss sharing

The ideal from a macro perspective: Social and economic development

Early literature on modern “Zero-interest” economics: inflation-free, end of national debt and mass poverty, private funding for vital social sectors

# The Double Mudaraba Concept (1)

- What the Mudaraba Is: an Association between the Rabb-el-Mal (Financier) and the Mudarib (Entrepreneur) where Profits and Losses are Shared Based on an Agreed-Upon Ratio
- All Bank Relationships Are Based on Double Mudaraba

# The Double Mudaraba (2)

- First Mudaraba: (a) Depositor as Rabb el Mal and (b) Bank as Mudarib
- Second Mudaraba: (a) Bank as Rabb el Mal and (b) “Borrowing” Client as Mudarib

# Updating Islamic Finance

- Early works on Islamic Finance: The role of Pakistani and other scholars
- Early experiments:
  - Scattered small scale and usually short-lived experiments in the Indian subcontinent and elsewhere
  - In Malaysia, since 1963 the Muslim Pilgrims Savings Corporation (now Tabung Haji or Pilgrims Management and Fund Board)
  - In Egypt, the Mit Ghamr experiment (1963-67)

# Evolution

- Three Stages of Islamic Finance
  - First Stage: National Experiments (1975-1991)
  - Second Stage: Globalization and Islamic Finance (1991-2001)
  - Third Stage: After September 11 (2001-Present)

# Economic and Political Context of Modern Islamic Finance (1)

- Pan-Islamism
  - The Arab Cold War and the decline of Nasserism
  - From Pan-Arabism to Pan-Islamism
  - 1970: The Creation of the Organization of the Islamic Conference (OIC)

# Economic and Political Context of Modern Islamic Finance (2)

- The Petrodollar Windfall
  - The new oil supply-demand picture and the changing bargaining power of oil producing countries
  - The quadrupling of the price of oil (1973-74)
  - Calls for a “New International Economic Order” (NIEO) and “Southern” solidarity against the “North”
  - Assertiveness and financial experimentation

# First Stage

- Pan-Islamism and the new interest in Islamic economics and finance
- A new Ijtihad: redefining financial concepts and practices to devise a system at once consistent with religious precepts and viable
- Third OIC meeting in Jeddah (1972): a comprehensive program submitted to the Ministers of Foreign Affairs
- 1973: King Faisal committed to the idea of an Islamic banking system

# The Islamic Development Bank (1)

- The 1974 Organization of Islamic Conference summit in Lahore: creation of the Islamic Development Bank:
  - 44 countries were founding members; largest shareholders Saudi Arabia (25%), Libya (16%), the UAE (14%) and Kuwait (13%)
  - Subscribed capital: 2 billion Islamic Dinars (2 billion Special Drawing Rights)
  - Goals: to foster development in the Islamic world, inject funds where needed, provide fee-based services and profit-sharing financial assistance to member countries

# The Islamic Development Bank (2)

- goal to become the cornerstone of an Islamic banking system by promoting, through direct participation, training and advice, the creation of Islamic institutions;
- Became operational in 1975;
- Later creation of the Islamic Research and Training Institute (IRTI), a unit of IDB dedicated to research and training in Islamic economics and finance.

# Principles

- Interest-free banking
- Focus on profit-and-loss sharing
- Murabaha and other cost-plus financing vehicles acceptable
- Preference for real estate and commodities
- Strict interpretation: Stocks, bonds, insurance and most innovative financial products not acceptable

# Differences with Conventional Banks

- Do not transact on the basis of credit or cash loans; use of specific Islamic contracts as substitutes
- No previously fixed yield
- Relationship based on participation in risks and rewards (on the basis of pre-agreed ratios)
- Fair profit; No profit maximization goals; developmental and social goals
- Shariah advisors

# The First Islamic Banks

- Main Players: Gulf States (esp. Saudi Arabia) for capital; Egypt, Pakistan for manpower
- Dubai Islamic Bank: first commercial institution created in 1975
- Kuwait Finance House (1977)
- Faisal Islamic Bank of Egypt (1977) and Faisal Islamic Bank of Sudan (1977)
- Jordan Islamic Bank for Finance and Investment (1978)
- Bahrain Islamic Bank (1978)

# Beyond Commercial Banking

- Islamic Investment Company in Nassau (1977)
- Islamic Investment Company of the Gulf in Sharjah (1978)
- Shariah Investment Company in Geneva (1980)
- Bahrain Islamic Investment Bank in Manama (1980)

# Main Characteristics

- Typically, one or two Islamic banks in those countries where Islamic banks were allowed
- Ambiguous regulatory environment (often outside central bank regulation)
- International regulatory environment: pre-deregulation

# Early Developments

- Full Islamicization of banking: Pakistan (1979), the Sudan (1982) and Iran (1983)
- Attempts at common standards and practices: the International Association of Islamic Banks (since 1977) and the Islamic encyclopedia

# The First Transnational Groups

- The DMI or Faisal Group: Dar al Maal al Islami founded in 1981, headquartered in Geneva
- The Al-Baraka Group: Dallah Al-Baraka group founded in 1982 by Shaikh Saleh Abdullah Kamel
- “Transnational” character

# The Emergence of Two Models

- “Gulf” Model
- Malaysian Model (since 1983)

# Transition to Second Stage

- From Ideal to Reality
- Trial and Error and Growing Pains (“Teething Problems”)
- New Ijtihad
- Problem of Fragmentation and Lack of Harmonization

# Questioning the Future of Islamic Banks

- The decline of oil prices after 1981
- Losses in gold, foreign currencies and commodities
- The Islamic Money Management Companies (IMMC) episode in Egypt (1984-1988)
- The collapse of BCCI (1991) and losses of FIBE

# Changing Political-Economic Context

- The End of the Cold War and the New Role of Financial Markets
- Financial Globalization and Technological Change
- Role of Islamic Middle Classes
- Towards Global Regulation

# The Second Stage (1991-2001)

- Modernist Interpretations
- Impact of the Downgrading of Interest
- New Players
- The Malaysian model

# The Transformations of Islamic Finance

- Creation of Islamic windows by conventional establishments
- Islamic subsidiaries of Western institutions
- Product innovation and non-Muslims customers
- Islamic Finance outside the Islamic world

# Status of Islamic Banks

- Slowly Integrating Within the Global Economy
- Still a Niche Industry
- Regulatory and Harmonization Challenges

# Country Differences

- Diversity of Historic Experiences and Political, Social and Economic Contexts (context of Islamicization; economic and political situation; experience in banking and finance; government commitment)
- Benchmarking Effects
- Pressures for Standardization, Harmonization and Convergence with International Norms

# September 11 and Islamic Finance

- Attitudes Toward Islam
- New Awareness of Islamic Finance
- Policies and Proclamations
- The Treasury Department
- Impacts of Accounts Freezings and the Financial War

# Toward a Third Stage

- End of Go-It-Alone Approaches
- Islamic Revivalism
- Capital Outflows
- New Coordination Mechanisms
- Role of Malaysia, Bahrain and Other Countries

# Other Factors

- Sukuk and the New Secondary Markets
- Evolution of the Price of Oil
- Politics and the “War on Terror”

# Vying for “Islamic Hub” Status

- Bahrain
- Malaysia
- Singapore
- UK
- Many Others

# The General Council of Islamic Banks and Financial Institutions

- GCIBFI
- Previous experience of the International Association of Islamic Banks
- Goals
- Obstacles to overcome

# The International Islamic Rating Agency

- The IIRA
- Role and prospects
- International benchmarks

# The Islamic Financial Services Board

- The Coordination of bank supervision and promotion of Islamic finance
- Created in 2002 in Malaysia
- The role of the International Monetary Fund, the Islamic Development Bank, the Bahrain Monetary Agency and Bank Negara Malaysia

# The International Islamic Financial Market

- IIFM and the creation of an interbank Islamic money market
- Liquidity and competitiveness
- Prospects
- The need for a critical mass
- The Liquidity Management Center (LMC)

# AAOIFI

- The Accounting and Auditing Organization for Islamic Financial Institutions
- Created in 1991 in Bahrain
- Post-2001 Evolution: greater urgency of standardized norms, cooperation with national and international bodies
- Compulsory in Bahrain and a few other countries, voluntary elsewhere; benchmarking effect

# Examples of Regionalization

- Largest Arab Islamic Banks Typically Major Players in a National Market (Al-Rajhi, Kuwait Finance House, Dubai Islamic Banks)
- All Three Now Moving to New, Often Distant and Different Markets

# KFH in Malaysia

- Acquisition of an interest in RHB Capital, Malaysia's fourth-largest bank (February 2007), becoming the largest foreign direct investor in Malaysia.
- May invest more than \$3.4 billion in Rashid Hussain and RHB Capital.
- According to KFH, goal is to create a “mega” bank run as an “Islamic brotherhood.”

# Islamic Products

- Equity-Based: Mudaraba, Musharaka
- Sale-Based: Murabaha, Istisnaa, Salam
- Leasing-Based: Ijara, Sukuk