

# Islamic Economics and Finance

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The relevance of religious belief to the material world is often overlooked, even by the devout, but any study of the major religions will show that there is a considerable body of teaching on how believers should conduct their working lives, undertake monetary transactions and manage their financial assets. Economic activity involves human behaviour, and this introduces a moral dimension, as humans have choices and their actions can be a force for good or bad. Seeking divine guidance for economic decision making can be helpful in making the right choices, and can ease consciences where decisions affect the lives of others. Economic governance, whether at national or corporate level, can be a lonely and thankless task, but if those exercising responsibility feel they are carrying out their duties on behalf of the Almighty, this can inspire and motivate themselves and others.

## **Islamic law and economics**

All three monotheistic religions—Judaism, Christianity and Islam—provide general guidance on everyday living including on economic and financial affairs. For Muslims the authoritative source of guidance is the Holy Quran, the revealed word of Allah, and the *Hadith*, the sayings and practices of the Prophet Muhammad and his companions, referred to as the *Sunnah*. Since the time of the Prophet over 1400 years ago there have always been differences of opinion in the interpretation of how this guidance should be interpreted and applied. The Islamic scholars who specialised in this interpretation are referred to as the *ulema* or *fiqhaa*, the

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latter being derived from *fiqh*, the study of Islamic law. The study of economic and financial transactions from an Islamic perspective is referred to as *fiqh muamalat*, that branch of Islamic jurisprudence that is concerned with commerce and other economic activities. The leading Islamic bank in Indonesia, the most populous Muslim country, is Bank Muamalat, an institution that tries to apply *fiqh muamalat* in all its financial dealings.

Although only a minority of Muslims are Arab, *fiqh* scholars are normally expected to read Arabic, the language of the Holy Quran and the commentaries on the *Hadith*. Translations are available, but do not capture the exact meaning of the sacred texts. Arabic terms are used for Islamic economic concepts and *shariah* compliant financial products as there are no precise equivalents in English with respect to modern economics and contemporary finance. These Arabic terms are used in this article, with a glossary provided at the end to help the reader.

Islamic law is usually referred to as *shariah*, but this should not be equated with secular national laws enacted by nation states, including commercial law. *Shariah* provides guiding principles for everyday living, but adherence is a matter of conscience and belief, and not of state enforcement. In most countries, Islamic banking is a matter of choice, and it is only in the Islamic Republic of Iran that all banks must comply with *fiqh muamalat* under a Usury Free Banking Law enacted in 1983.

To be *shariah* compliant a financial institution must have a *shariah* board comprised of specialists in *fiqh muamalat* who approve all products offered by the institution, including deposit and financing facilities. Such compliance can be provided at national level, as in Iran, or at institutional level, as in most of the Muslim World and the West, including the United Kingdom, where Islamic Bank of Britain, HSBC Amanah and Lloyds TSB have their own *shariah* scholars. In such cases *shariah* compliance has effectively been privatised. Compliance can also be outsourced, as in the case of *shariah* compliant managed funds, where the Dow Jones Islamic Indices, which also has its own *shariah* board, can supply screening software to determine what equities are acceptable investments from an Islamic perspective.

The rulings of *shariah* scholars are referred to as *fatwa*, and these are derived through reasoning and attempting to apply *fiqh* to contemporary economic and financial transactions. This process is referred to as *ijtihad*, and in practice involves reading the contractual documentation governing

economic activity and financial transactions and ensuring that it is consistent with *shariah*. Where each institution has its own legal documentation for its financial products, devolved *shariah* compliance becomes necessary. The lack of consistency of *fatwa* is sometimes criticised, but this reflects the diversity of financial institutions and the differentiated nature of financial products.

Apart from in the Islamic Republic of Iran where all laws passed by the *majilis* or parliament are subject to scrutiny by the religious authorities to ensure they comply with *shariah*, in all other jurisdictions national laws prevail over *shariah*. Many Muslim countries have *shariah* courts which operate in parallel with national courts, but it is the latter that are usually involved in commercial disputes, and not the *shariah* courts whose remit is largely confined to family matters such as divorce and inheritance. Sometimes *shariah* courts can be referred to for arbitration, but this is only if the parties to a contract freely agree to such recourse and this is specified in the contract.

*Shariah* can be upheld by national courts, but this is only where it is consistent with national law, as in most states the *shariah* courts have no independent powers of enforcement. Islamists who would like to see religion having more political influence favour enhancing the powers and remit of *shariah* courts, but this is not the policy of most Muslim majority states. The limited commercial and modern contract law expertise of most *shariah* judges means they lack the competency to adjudicate in financial disputes, although this deficiency could be addressed through relevant training. In Malaysia the national courts can engage *shariah* advisors, but their advice is not mandatory.

## What is Islamic economics?

Given this fusion of traditional religious ideals with modern compliance methodologies, Islamic economics should not be viewed as a throw back to medieval times and a supposedly unenlightened past, an alien phenomenon or a mere facet of Islamist politics in the Muslim World. Rather there are parallels between the modern ethical finance and socially responsible investment movements and Islamic finance, with investors not only concerned with financial returns, but also with how their money is utilised and its implications for resource allocation.

It is Islamic banking and finance that has been most in the headlines since the first oil boom of the 1970s and the emergence of the Muslim heartlands as financial superpowers. The principles of Islamic finance are, however, based on Islamic economic theory, and to understand the former, some knowledge of the latter is required. Islamic economics is not a replacement or substitute for mainstream economic theory, but rather of approaching economics from a moral perspective and rejecting the excesses of both capitalistic markets and command economies. A utilitarian approach which sees the motivation of economic behaviour in terms of the maximisation of individual material satisfaction is rejected. For devout Muslims, the aim of man is to serve the Almighty by promoting social good, and the acquisition of material goods is a means, not an end.

What does this mean for economic policy? It would be mistaken to associate Islamic economics with any particular political ideology or social ideal. The stress is on justice in economic transactions, not on income or wealth equality. Markets are seen as a natural mechanism for allocating resources, but the justice of market outcomes will depend on the behaviour of the participants. Responsibility to Allah comes first, not unrestrained freedom—the stress being on social obligations rather than individual rights. Private property is recognised, as although all assets ultimately belong to the Almighty, humans have responsibility for how assets are utilised—the Muslim concept of *khalifah*, accountability to Allah for how resources are managed, being similar to the Christian idea of stewardship.

## **Taxation and monetary policy**

In most Muslim countries, fiscal and monetary policy is not influenced by religion, although inflation is of concern because of its distorting effects and its disproportionate impact on the poor. Traditional Islamic taxes mainly applied to land holdings, with *kharaj* related to land area with adjustments made for its potential rather than production. This encouraged a more productive use of land holding as owners would be liable irrespective of output levels.

*Zakat*, which can be regarded as a form of alms giving, is often described as a wealth tax. It is one of the five pillars of Islam, with the devout expected to pay an annual amount based of one fortieth of their wealth. There are differences over what constitutes wealth, with financial assets

clearly included, but residential and commercial property usually excluded. In Malaysia the administration is formalised, with Muslims who pay *zakat* permitted to offset these payments against income tax liability. In the oil rich countries of the Gulf there is no income tax, hence offsetting is not a possibility. Usually states control the *zakat* collection, often through a special ministry, but revenues are designated for social assistance and cannot be used to finance general government expenditure.

Conventional monetary policy presents difficulty from an Islamic perspective given the prohibition of *riba* or interest. In practice, as most Muslim countries peg their currencies to the United States dollar, they do not pursue active monetary policies, although there are variable rates at which central banks make funds available to the commercial banking sector which tend to be adjusted in line with Federal Reserve policy. Islamic economists are unhappy about this, but have not advanced persuasive alternatives, other than suggesting variations in reserve requirements and credit rationing as monetary instruments.

In Bahrain, *sukuk* securities based on *salam* contracts are used to finance government deficits as an alternative to conventional treasury bills. With these contracts funds from the investors are used to make an up-front payment (*salam*) to the treasury for the purchase of a state owned asset. After a period of three months the asset is duly transferred, but immediately the treasury purchases it at a higher price. The mark-up represents the return to the investors, usually Islamic banks. As the banks acquire these assets, they have fewer funds to advance to their clients; hence there is a tightening of the money supply. These transactions are regarded as *shariah* compliant as the mark-ups do not vary with interest and the *sukuk* securities are asset backed, rather than being pure monetary instruments.

## Justice in transactions and reward

Although markets are regarded as the normal method of economic interaction, there are *shariah* concerns that market outcomes can be exploitative, and recognition that regulation may be required to ensure justice to participants. Traditional *souk* or markets included an institution known as the *hisba*, which was a trading standards authority that ensured fair weights and measures, and that in the case of foodstuffs that it was fit for human consumption. The verification that meat is *halal* is a particular concern,

and in recent years the sacrifice of animals for distribution to the poor and needy during pilgrimage or *hajj* has been formalised. The Jeddah based Islamic Development Bank manages a scheme whereby pilgrims are encouraged to purchase certificates which cover the costs of the animals slaughtered in abattoirs under clean and humane conditions rather than the pious undertaking such sacrifices themselves.

In *shariah* every reward must be earned through effort, wages and salaries being the reward for legitimate and honourable work which applies to most occupations which are legal. As private ownership is recognised, rent is also viewed as a legitimate reward, but owners must have clear contractual responsibilities, as in the case of operating leases, and cannot pass on all their liabilities to tenants, as is often the case with financial leases. In the case of a building or equipment for example, it is the owner who is responsible for the insurance, not the lessee. Profit is also viewed as a legitimate reward, as it relates to risk taking and entrepreneurial activity. Risk is recognised as unavoidable, and business cycles are seen as inevitable. In this context the participation in risky ventures is seen as beneficial, as with partnership contracts such as *mudaraba* and *musharaka* which involve profit and loss sharing. These forms of contracts will be explained more fully later. While sharing in risk reduces the burden for each participant, this is not the case with speculative risk taking, which may involve deliberately increasing market volatility or cornering markets through monopolistic practices to make gains at the expense of others. Such speculative activity is forbidden, as is gambling, *muqamarah*, or games of chance, *maysir*, where the returns to those who win are at the expense of the losers.

In the Holy Quran, explicit provision is made for inheritance which governs the estates of those who wish to comply with *shariah*. The faithful have discretion over one third of their estates, but the other two thirds is subject to a formula which is regarded as fair to all relatives of the deceased. Children have a share of inheritance, and not merely spouses, which can result in children being excluded from the estates of their parents in the event of re-marriage. Male relatives are entitled to twice the share of females, a practice that attracts criticism from some in the West, but in Muslim society males are responsible for the financial upkeep of their families, and income that women inherit or earn can be spent entirely at their own discretion.

## The prohibition of *riba* and returns to bank depositors

There has been much debate about whether *riba*, which is explicitly prohibited in the Holy Quran, should be equated with interest charged on bank loans and paid to those with savings accounts. As *riba* refers to any addition to a principle sum, the interpretation that this should apply to banking transactions seems clear.

The case against earning interest on savings is that it represents a virtually risk free return for no effort, especially if deposits are guaranteed. With Islamic banks, savers, usually referred to as investors, earn a return, but it is related to bank profitability and is not simply determined in relation to minimum lending rates and the dictates of monetary policy. Islamic banks offer investment *mudaraba* deposits, with depositors viewed as stakeholders who earn a just reward for sharing in the banks' risk. Under *shariah*, deposits cannot be guaranteed, and depositors could suffer a capital loss, but in practice Islamic banks are cautious in their management of risk, and such losses do not occur. The *shariah* boards permit Islamic banks to pay a proportion of their profits into a profit equalisation reserve which is used to maintain a profit payout to depositors in the event of the bank suffering a cyclical decline in profits or even losses. It should be noted that although the investment *mudaraba* depositors are important stakeholders in an Islamic bank, they are not shareholders. Equity investors aim to make capital gains, but investment *mudaraba* depositors, like conventional savings depositors, only aim to have the nominal value of their capital preserved, plus a profit payment. In the event of bankruptcy, the investment *mudaraba* depositors will have a prior claim on any remaining assets, whereas the shareholders will typically lose all their investment.

Islamic banks, like their conventional counterparts, offer current accounts, but in the case of the former no interest is payable. The attraction for Muslims of current accounts with Islamic banks is that assurance is given that their deposits will not be used to finance *riba* based lending. Conventional banks such as HSBC Amanah or Lloyds TSB which provide *shariah* compliant current accounts must keep these funds segregated from other deposits and account for them separately. The transactions services available to *shariah* compliant current account holders are identical to those for conventional depositors and include direct debit and standing order facilities, as well as debit cards to make point of sale purchases or

withdraw cash from ATM machines. However, no overdrafts are permitted, as these would incur interest charges.

Islamic Bank of Britain offers a treasury account for businesses and individuals of high net worth, the minimum deposit being £100,000. This is structured using the *murabaha* principle, with the bank placing the deposits with a broker who invests the funds in commodities acquired through the London Metal Exchange. The commodity is sold on with the purchaser making a deferred payment. A mark-up is charged to reflect the credit being given. The mark-up is not interest, as there is a real trading transaction, not a loan. The mark-up is shared with the treasury account holder, enabling a competitive return to be paid in line with that on conventional treasury accounts.

## Financing without interest

Most of the finance provided by Islamic banks is commodity related, *murabaha* being the most commonly used financing instrument. A client wanting a specific good can ask an Islamic bank to purchase it, and resell it to him or her at a mark-up with the client paying through a deferred payment or a series of payments. As the bank can buy the good in bulk, it may be able to obtain a discount, but in any case the mark-up will represent its profit on the transaction. To justify the mark-up the bank takes on ownership risks, as if the good is defective the client may refuse delivery, or if a fault is discovered after delivery the client could sue the bank rather than the supplier. As much *murabaha* in the Gulf economies is to cover import payments, it can be an efficient form of trade financing. Usually with conventional trade finance importers have to seek letters of credit from their banks to satisfy exporters that they are financially capable of making the payments. As an Islamic bank is the first purchaser with *murabaha* letters of credit are usually not required, saving the importer a significant cost.

For longer-term financing, *ijara* or leasing is frequently used by Islamic banks, although there are also specialist *shariah* compliant leasing companies. *Ijara* corresponds to an operating rather than a financing lease, as the owner of a leased asset cannot simply transfer all risks and responsibilities to the lessee as is the aim of a financing lease. In Islamic finance the objective is risk sharing to reduce the liability of each party and not simply risk transfers which unjustly favour one party such as a landlord. As previously

mentioned, the owner of a leased asset under *ijara* will usually be responsible for insurance of the asset, while the lessee will be responsible for the interior maintenance of a building and the servicing of equipment. Hire purchase is also possible, this being termed *ijara wa iqtina*, with the ownership of an asset passing to the lessee at the end of the lease period either as a gift if purchase instalments were specified in the contract in addition to the rent, or in return for a final payment.

Retail clients often want cash advances rather than tied credit, but Islamic banks cannot provide overdrafts on which interest is payable. To overcome this constraint *tawarruq* can be used, a contract under which a bank acquires a commodity for a client as with *murabaha* and delivers it to the client, but the client subsequently sells the commodity to an affiliate of the bank. The sale proceeds are credited to the client's current account, while deferred repayments are made to the bank to cover the cost of the initial purchase, plus a mark-up which represents the bank's profit on the transaction. Some critics object to this method of financing as although formally it complies with *shariah*, in substance it resembles a cash advance with only a credit risk for the bank. The mark-up is pre-determined and relates to the credit risk rather than the profit from a legitimate business activity.

Until 2003, Islamic banks provided debit cards to their current account holders, but not credit cards where unpaid balances incurred interest charges. To provide account holders with greater flexibility, Islamic banks in the Gulf and Malaysia developed credit cards where the revenue came from monthly subscriptions rather than interest. Credit limits are determined by the financial worth of the cardholder, with those wanting a higher limit paying a greater monthly fee. The fee applies whether or not the credit is used, but if clients are near their limits, they will not have the flexibility to make additional discretionary purchases, the aim of most credit card holders.

### ***Shariah* compliant corporate finance and Islamic investment banking**

Although *murabaha* is suitable for inventory finance and *ijara* for leased assets, for project financing other instruments are preferable as it usually involves much more substantial funding. *Istisna* was traditionally used for

the finance of manufacturing in Islamic jurisprudence, as at the time of the financing no good existed, merely plans for its production. This contract was applied in Malaysia to project financing in the early 1990s, and more recently its use has spread to the Gulf, not least because of the increasing number of infrastructure projects following the latest oil price boom. With *istisna* a bank purchases the supplies necessary for a project on behalf of a developer or contractor, and can even cover the wage bill and other construction expenses. Initially there may be no repayments to the financier, but once the project is completed and delivered to the client, the payment made to the developer can be used to refund the bank expenditures. A mark-up will be added, the size reflecting the time to repayment and the risks in the contractor not fulfilling their obligations and defaulting on the repayments. Often the contractor will be required to provide a conventional performance bond to mitigate the risks of deadlines not being met or of work not being completed to the satisfaction of the client.

The financing of large projects involves a considerable degree of risk, and as most Islamic banks are of limited size, a single project could account for a substantial portion of their assets which it would be imprudent to take on. There are two solutions to this problem—syndication through a *musharaka* contract, or securitisation of assets involving the issuance of *sukuk*.

*Musharaka* represents a partnership agreement whereby the investors share in the profits and losses of a business venture, with the shares being specified in the contract but the actual profit and losses reflecting business conditions. It is similar to equity investment where the shareholders receive dividends according to their ownership shares, but less liquid than investing in listed companies, as normally there is no trading in *musharaka* investments, which have more in common with private equity. In *musharaka* the concern is to protect the partners from each other's actions, and therefore the principle of mutual consent applies, and investors cannot act unilaterally by, for example, selling their stake or using it as collateral without seeking the consent of their co-investors. The objective of investors in public and private equity is usually to make capital gains, but with *musharaka* the emphasis is on income rather than asset appreciation. Indeed *musharaka* can be offered as a debt instrument, with investors placing their funds in a special purpose vehicle for a fixed period and on termination the nominal value of their capital is refunded as in a loan agreement. Private equity, in contrast, does not have a pre-determined

exit date. However, unlike a loan arrangement the investors in *musharaka* do not earn interest, but rather a profit share. Any losses have to be recognised and apportioned to investors in the year that they occur rather than being deferred, as such provisioning avoids debt and ensures there are no unjust inter-generational transfers.

Most Islamic banks are retail undertakings, but some Islamic investment banks are now emerging, notably CIMB Islamic of Malaysia, and international investment banks are increasingly keen to attract *shariah* compliant business. One of the major attractions of the business is *sukuk* issuance, which in 2007 exceeded \$40 billion. Investment in conventional bills, bonds and floating rate notes is forbidden in Islam as such securities pay interest. *Sukuk* securities are based on *shariah* compliant structures such as *murabaha* which pays a mark-up, *ijara* that pays a rent or diminishing *musharaka*, where there are profit payments plus regular repayments of the capital invested. The *murabaha sukuk* have similar financial characteristics to fixed rate bonds, whereas under the *ijara* rental agreements payments vary, making the resultant security similar to a floating rate note.

As pure financial instruments cannot be traded under *shariah*, *sukuk* are asset backed; hence when investors buy and sell they are trading their rights to a real underlying asset. The asset may be a parcel of real estate, equipment or even a commodity, but the asset must be specified in the contractual documentation. Project finance in the Muslim World is increasingly undertaken using *sukuk*, as the financing can be long term, but the investors have the option of selling at any time before maturity providing a willing buyer can be found. There is an active market in *sukuk* in Kuala Lumpur, but markets elsewhere, including in the Gulf, are far less liquid. With *sukuk* the pricing reflects the risk weighting of the issuer based on the probability of default. *Ijara sukuk* pay a variable return that can be indexed to conventional rates, including LIBOR, the London Inter Bank Offer Rate. Although this is a rate of interest, the *sukuk* payments under *ijara* are legally designated as rents, and therefore are *shariah* compliant despite the pricing. There has been some criticism of *sukuk* pricing and structuring by *shariah* scholars, but it is recognised that investors want to hold debt instruments that pay a return and not simply equity which involves a greater degree of risk sharing and arguably justification for the returns paid.

## Screening shares for *shariah* compliance

Stock market investment is permissible in Islam, even though equities are not a traditional *shariah* compliant financing instrument. In contrast, gambling is prohibited as this is seen as a zero sum game where for every winner there are many losers, some of whom become addicted to betting and are exploited by gaming establishments. Equity investments are recognised as being in real assets as they confer ownership rights, and in a stock market investors who enjoy capital gains are not exploiting those who suffer losses because of poor investment decisions. Investment must be in ordinary rather than preference shares, as the latter are viewed as debt instruments which yield a pre-determined return to the investor who has a higher claim on any assets remaining in the event of bankruptcy. Ordinary shareholders share in corporate risk, but as preference shareholders take on less risk, rewarding them first is not seen as justified.

*Shariah* compliant investors are concerned about the types of companies into which they place their money, a concern shared by ethical investors and those advocating socially responsible investment. In the case of *shariah* compliance the major sectors excluded include the shares of *riba* based banks, companies involved in alcohol production or pork distribution and gaming operations and media organisations involved in the dissemination of pornography. The rationale and morality behind these exclusions is clear, as it can be traced to specific verses in the Holy Quran and the *Hadith*. Other exclusions have been introduced by contemporary *shariah* scholars themselves, and these include the exclusion of tobacco companies on the grounds that smoking is a form of gradual suicide which is forbidden in *shariah*. Armaments companies are also excluded, largely because of political arguments, not least that leading armaments companies outsource sub contracting to Israel and the armaments themselves have caused destruction in Muslim countries and societies.

There are some companies that are engaged in businesses activities which are acceptable, but may have some revenue that derives from unacceptable activities. Supermarkets, for example, mainly retail food products, most of which are *halal*, but there may be some sales of pork products and alcohol. Similarly, hotel chains mainly provide overnight accommodation and meals, but some will have bars and even casino operations on

their premises. Not surprisingly, there has been much debate over whether investing in such companies is permissible, with one response being that if the revenue from the unacceptable activities is below five or even ten percent of total sales, the company should not be excluded. Any *haram* profit derived from this revenue can be donated to charity, a process referred to as purification.

In addition to the concern over business activity, there is also a worry over how business is financed and the types of assets held. Financial screens have been developed by the Dow Jones Islamic Indices to determine what is acceptable. If a company has debt exceeding one third of its total assets as measured by market capitalisation in the case of listed companies, then it is regarded as unacceptable from a *shariah* perspective. Highly leveraged companies are in any case very risky and often a speculative investment. The one-third criterion is derived from the Islamic inheritance provisions that Muslims can exercise discretion over one third of their estates. Where companies derive more than one third of their earnings from financial holdings of interest earning assets, this is also regarded as unacceptable. There is also a concern with debt receivables, as these are usually calculated with implicit interest charges which relate to the time period until settlement is due. Companies with receivables that exceed forty-five percent of their market capitalisation are deemed unacceptable. As market capitalisation can vary considerably in volatile conditions, the ratios are calculated using a trailing twelve-month average of market capitalisation based on daily closing stock prices.

In practice, the exclusion of conventional banks is the major factor that influences the performance of *shariah* compliant equity investment relative to unscreened portfolios, largely because breweries, distilleries and gaming companies account for only a minor portion of capitalisation in most markets. In 2007, for example, *shariah* compliant indices outperformed their conventional counterparts largely because the bad debt provisions made by many banks due to the sub-prime crisis adversely affected their share prices. *Shariah* compliant investors, however, lost heavily during the dot com collapse and many were heavily exposed to companies such as Enron, which on the basis of the information it provided seemed an acceptable energy company of interest to those in the Gulf with knowledge of energy markets.

## Islamic approaches to financial risk and *takaful* insurance

The early advocates of Islamic finance back in the 1950s and 1960s thought Islamic banks should be established to serve the poor and would be non-profit making credit unions providing microfinance. Although there were some experiments with such institutions in Pakistan and Egypt, it was in the oil rich Gulf in the 1970s that Islamic banking took off, the first major institution being Dubai Islamic Bank which opened for business in 1974. Its clients were pious merchants and traders who had considerable family fortunes. They wanted corporate finance to expand their businesses, and *murabaha* trade finance soon took off. The aims of those seeking financing were no different from those seeking conventional funding, the only difference being that the pious merchants wanted the contracts with the bank to be *shariah* compliant. Therefore Dubai Islamic Bank would evaluate its credit risks in the same way as conventional institutions, appraising through credit scoring and other standard techniques, including an examination of business plans and cash flow projections. Previous credit history also mattered, as did the reputation of the merchant and his wider family, not least because obligations were often taken on by whole extended families.

In the Holy Koran, leniency is urged to those in debt who are unable to meet their obligations, and in *fiqh* lenders are not allowed to levy an additional charge to those who pay late as this would constitute *riba*. This inevitably creates a potential moral hazard problem if borrowers know that they will not be penalised for late payments. To counter such credit risk, Islamic banks were subsequently allowed by their *shariah* boards to levy an additional charge, provided the bank itself did not profit, with the proceeds given to charity. Where debtors get into genuine difficulties, but the situation is recoverable, Islamic banks are permitted to provide an interest-free *qard hasan* loan to enable the client to meet their existing obligations under *murabaha*, *ijara* or other *shariah* compliant contracts. An arrangement fee can be levied for such bridging finance to cover the bank's costs, but the bank should not profit from the refinancing, as this would constitute exploitation of a debtor.

Conventional financial risks also apply in Islamic finance, including liquidity and operational risk. The Islamic Financial Services Board which is based in Kuala Lumpur is responsible for advising regulatory agencies

worldwide on how they should assess the risks facing Islamic financial institutions, including how the Basel II guidelines can be adapted. When specifying liquidity requirements for Islamic banks for example, the regulatory authorities must appreciate that they cannot hold conventional treasury bills or participate in repo operations as these involve dealing in *riba*. Instead, Islamic banks can hold *salam sukuk* as liquid instruments, or place deposits through the inter-bank market in treasury *murabaha* facilities. Operational risks which involve staff malpractice and fraud also have to be controlled by Islamic banks, although as their staffs are religiously motivated to work in a pious environment, there is a greater degree of trust, and indeed empirical evidence suggests that there are very few instances of deliberate deception and dishonest dealings.

There are *shariah* concerns about the exploitation that can arise in conventional insurance contracts, not least the element of *gharar* or legal ambiguity with policyholders often uncertain what their rights are when making a claim and the terms and conditions often hidden in small print. *Shariah* boards are responsible to ensure that contracts are clear and transparent, and just to all the parties. There are also concerns about conventional insurance companies holding bonds and floating rate notes, and Islamic insurance providers, usually referred to as *takaful* operators, hold their assets in *sukuk* or equities which are screened for *shariah* compliance.

Organisationally there are concerns that with conventional insurance there are conflicts of interest between shareholders' pursuit of high dividends and capital gains at the expense of policyholders. It is regarded as exploitative for shareholders to be benefiting from the misfortunes or fears of the policyholders. Consequently mutual insurance is preferred to listed public insurance companies, as this avoids conflict between different stakeholder groups. However it is recognised that mutual organisations face limits on the capital that they can raise and that there are advantages in bringing in external equity. Consequently two *takaful* models have been developed, a *wakala* contract based on trust, and a *mudaraba* contract based on profit sharing. Under the *wakala* contract premiums are treated as donations, *tabarru*, into a common pool, with the proceeds from the pool used to cover the claims of those experiencing misfortune through the cost of accidents, medical fees or losses due to theft, fire or other hazards. Life insurance can also be covered in this way, this being referred to as family *takaful*, the stress being on the beneficiaries and not the deceased.

*Wakala* and *mudaraba* companies can be listed, but in the case of the former the shareholders' funds are kept separate from the *takaful* pool financed through *tabarru*, with the operator earning a fee for their efforts in managing the fund. The shareholders' returns will depend solely on the size of the fee and the ability of the manager to control costs, with only the *takaful* policyholders benefiting from the fund. Under the *mudaraba* model any profits from the fund are shared between the investors and the policyholders, but as the ratio is predetermined there can be no question of the shareholders profiting at the expense of the policyholders. Today the *mudaraba* model is mostly used in South East Asia and the *wakala* model in the Gulf.

## Conclusions

There are many sceptics about Islamic finance, including in the Muslim community, and some Islamic economists concerned with redistribution are disappointed about how the industry has evolved commercially. Nevertheless there is substance to *shariah* compliant financial contracts which are about much more than the mere substitution of Arabic words. Islamic finance is treated seriously by the Financial Services Authority in the United Kingdom which has issued regulatory guidelines and by the Treasury which has issued a consultative document on a proposed sovereign *sukuk* which will be sterling denominated. There are already over one trillion dollars' worth of assets which are designated as *shariah* compliant, illustrating the worldwide success of Islamic finance and its market appeal.

Many challenges remain and the financial products are often works in progress. Undoubtedly the most valuable contribution of the Islamic finance industry is the issues it raises about morality in financial dealings, even if all the questions are not answered. It attempts to reconcile the spiritual with the worldly, and act as a filter to the excesses of capitalism which all too often are driven by individual material greed with no social accountability. There is much that those from other religions and those with no religion can learn from the Islamic finance experience, and the challenge it poses to conventional assumptions.

## Glossary of selected terms

<i>Fatwa</i>	ruling of a <i>shariah</i> scholar
<i>Fiqh</i>	Islamic jurisprudence, <i>fiqh muamalat</i> being the branch concerned with commerce and other economic activities
<i>Gharar</i>	contractual or legal uncertainty
<i>Hadith</i>	sayings and practices of the Prophet Muhammad and his companions referred to as the <i>sunnah</i>
<i>Hajj</i>	pilgrimage to Mecca
<i>Halal</i>	permissible under <i>shariah</i> in contrast to <i>haram</i> which refers to activities or practices which are forbidden on moral grounds
<i>Hisba</i>	regulation of markets in the public interest and in a manner consistent with religious teaching
<i>Ijara</i>	operational leasing contract, hire purchase being <i>ijara wa iqtina</i>
<i>Ijtihad</i>	effort of a qualified <i>shariah</i> scholar to determine the implications of divine law for human endeavours
<i>Istisna</i>	project finance
<i>Khalifah</i>	responsibility of resource owners to the Almighty for the assets they control
<i>Kharaj</i>	land tax
<i>Majilis</i>	consultative assembly or parliament
<i>Maysir</i>	game of chance such as a lottery
<i>Mudaraba</i>	profit sharing partnership with only one of the partners providing the finance and the other having a return for risk sharing or entrepreneurial activity. Usually applies to bank deposits. The financier alone is responsible for any losses
<i>Muqamarah</i>	gambling
<i>Murabaha</i>	purchase and sale for a mark-up which is disclosed
<i>Musharaka</i>	profit and loss sharing partnership with the shares predetermined. Can be used for syndicated finance
<i>Qard Hasan</i>	an interest free loan, including by a depositor to a bank
<i>Riba</i>	interest or usury
<i>Salam</i>	purchase of a commodity for future delivery with the price paid in full in advance. Usually the commodity is subsequently sold for a higher price, prior to, or at delivery, with the margin representing the profit

<i>Shariah</i>	Islamic law as revealed in the Holy Koran and the <i>Hadith</i> , the sayings and deeds of the Prophet Mohammad
<i>Sukuk</i>	Islamic securities
<i>Tabarru</i>	contribution to a common pool to cover risks as with <i>takaful</i> insurance
<i>Takaful</i>	Islamic insurance usually provided on a mutual basis
<i>Tawarruq</i>	the ultimate purchaser in a <i>murabaha</i> transaction sells the commodity obtained spot for cash. It is equivalent to a cash advance or personal loan.
<i>Ulema</i>	learned scholars in Islamic jurisprudence
<i>Wakala</i>	trust, usually applied to a bank deposit or a trust or insurance fund
<i>Zakat</i>	wealth tax

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