1 Introduction to Islamic finance

Initial Scenario

Peter is from the UK. After the global financial crisis, caused by the exploitation of poor, sub-prime customers, he was concerned about the excesses of the banking system and started researching the moral values that underpin the capitalist economic system. As an economics graduate he had heard about Islamic economics and Islamic finance and decided to enrol onto a summer course at Durham University on Islamic finance so that he could learn more about the principles of Islamic economics and its financial system.

He was intrigued to learn that more than 500 Islamic financial institutions are operating worldwide today, claiming to manage assets worth USD 1.5 trillion. In Malaysia, the Islamic banking and finance institutions are set to capture 25% of market share, and it is expected that Islamic finance will be the mainstream method of finance in the Gulf region in the next decade. Even the UK Governments want the London financial markets to become a hub for Islamic finance.

But Peter wasn't that interested in investment banking, he wanted to see what could be done to help poor people be financially included. He asked one of his lecturers about Islamic microfinance, and learned it is a growing sector. Peter was intrigued: he always had an interest in development issues and plans to work for an NGO.

1.1 Islamic microfinance and financial inclusion

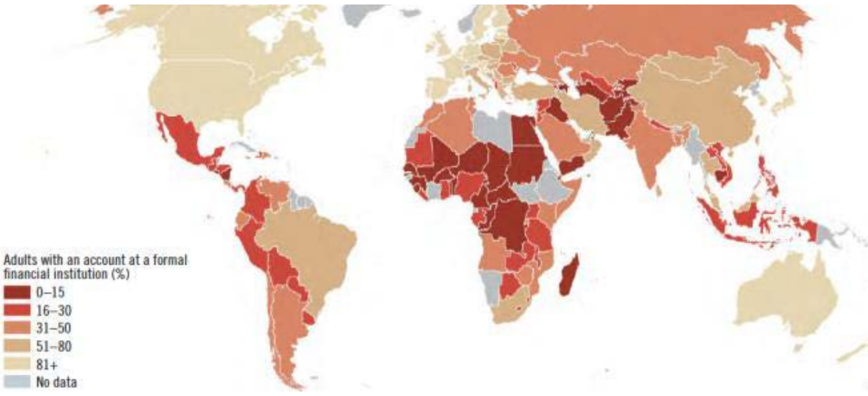
Islamic microfinance, contrary to conventional microfinance, follows the injunctions of Islamic law and does not pay interest on deposits nor does it charge interest on loans. Other instruments, where risks and profits are shared, or assets traded, are utilised.

Why is Islamic Microfinance, important from a development point of view?

Consider this:

According to the Global Financial Development Report (World Bank, 2014), **about 700 million of the world's poor live in predominantly Muslim-populated countries** and about 90 percent of the adults residing in Organisation of Islamic Cooperation (OIC) member countries consider religion an important part of their daily lives. Yet, only 18 percent of respondents in the MENA region (Middle East and North Africa) aged 15 years and older have an account at a formal financial institution; worldwide this figure stands at 50 percent. When asked why they do not have an account in a financial institution, 12 percent of respondents from the MENA region cite religious reasons, compared to only 4% in non-OIC countries.

Hence, we may assume that **many of these people voluntarily exclude themselves from formal financial markets because of religious requirements**. However, there are large variations: 34 percent of the unbanked Afghan population cite religious reasons for not having a bank account, while only 0.1 percent of Malaysians do so.



Source: World Bank Financial Inclusion Index 2013

Whilst it's difficult to establish the exact cause we can assume that one of the main reason for this phenomenon is that in Malaysia there are many Islamic financial institutions, while Afghanistan has only a few. But it is widely accepted that Muslims' access to formal finance depends on the extent to which Islamic financial institutions are present in a given country (Global Financial Development Report, World Bank, 2014).

Therefore the development of Islamic finance and especially Islamic microfinance is likely to make a significant contribution to the **Financial Inclusion of the poor** and it has the potential to make an even more substantial contribution in the near future.

The Consultative Group to Assist the Poor (El-Zoghbi and Tarazi, CGAP, 2013) has come to the conclusion that "*Shari'a-compliant financial inclusion represents the confluence of two rapidly growing sectors: microfinance and Islamic finance*." With an estimated 1.28 million clients, Islamic microfinance may still be a small industry, but it has the potential to grow very fast, considering the large number of people who are not using formal financial institutions in many Muslim majority countries.

1.2 Introduction to the Course

As we go through the seven units that make up this course, you will be progressively plunged into the fascinating emerging market of Islamic microfinance. In later units, we will cover the technical details: how products are delivered, how they are managed, how one manages an institution that provides these products, and how is performance (both financial and social) determined and measured. In earlier units (units 2 and 3), you will learn of the different products that can be offered to clients: what they are and what they are not.

But to get into these details, you must first have an understanding of what Islamic microfinance is, and that is the purpose of this unit. To start, we will learn about Islam, as you might wonder why and how the spiritual can have such a strong impact on something as temporal as the financial industry. This introductory section on Islam sets the ground rules, the foundation on which everything that follows is laid. From there, we will introduce the reader to the essential legal (and contractual) concepts within which the Islamic financial industry operates. These initial chapters give way to our subject matter.

1.3 Islam and economics

1.3.1 Foundations

Islam is a monotheistic and Abrahamic religion. The term "Islam" in Arabic means submission, and implies the total surrender of one's self to God, known in Arabic as Allah (Rahman, 1987). Like many religions, Islam prescribes a particular set of rites of worship and behaviours that will help its adherents to attain a higher state of spirituality and reward in the Hereafter.

Islam is based on the Qur'an a religious text considered by its adherents to be the verbatim word of God (*Allāh*), and the life, teachings and normative example (called the *Sunnah*) of the Prophet Muhammad (570–632 CE).

Shari'a

In Islam **Shari'a** (from Arabic: 'path') is regarded as divine law. It is broadly divided into two sets of rules: one relates to the obligatory worship of God (*Ibadah*) and the other relates to daily life outside the context of obligatory worship (*Muamalat*), including commercial and financial dealings. It derives from a number of primary and secondary sources: the Holy Book (Qur'an), the Sunnah (traditional accounts of what the Prophet Mohammed said or did during his life), Hadith (the narrative record of sayings and actions of the Prophet Mohammed), *Qiyas* (religious reasoning), *Ijma* (consensus of the Islamic community), and *Ijtihad* (interpretations and opinions of Islamic jurists on a particular issue). Shari'a is therefore not a single codified body of law and is open to interpretation by scholars to derive the divine intent. The opinions of such *Shari'a* scholars may differ and change over time.

Hence *Shari'a* represents both the ethical principles that underpin Islam and the path that leads the believer to salvation. *Shari'a* is not to be mistaken for the penal code, the *Hudud* that is mandated and fixed by the *Qur'an* and *Sunnah*.

At its foundation, the scriptures detail the faithful's obligations to God and the social interactions that are considered acceptable. These social interactions include prescriptions for economic life. The next sections discuss some features of Islamic economic system.

According to Islam, human beings are Allah's or God's vicegerent on earth. This means whatever a man or woman owns, belongs ultimately and absolutely to God. S/he is a trustee of God's resources in the earth. But God is the absolute owner of the resources.

However, according to the Qur'an, Allah allows human beings to inherit wealth, own it and use it, as evident from the following verses:

> *"The land belongs to Allah. He allows it, to be inherited by whomsoever, he pleases." (Qur'an, 7: 128)*
>
> *"Do they not see that we have created for them - among the things fashioned by us - cattle of which they become owners?" (Qur'an, 36: 29)*

We can call this a trust ownership. The appropriate understanding that comes from the trust ownership is that adherents will have to account for its use. In general there are three kinds of ownership: private, communal and state ownership. Private ownership is standard but some important utilities like water, canals, pastures and graveyards are communal assets, whilst the state owns mines, rivers and large tracts of land. Islam also introduced the concept of hybrid ownership through the creation of legal entities such as trusts (see chapter on 'Islamic social finance'.)

One of the means with which Humans should account for the use of resources is to appropriately share bounties with those in need. In a well-known hadith the Prophet Muhammad stated: *He is not a believer whose stomach is filled while the neighbour to his side goes hungry.'"* (Al Bayhaqi, Sunan Al-Kubra, 19049).

In essence, the Islamic faith does not allow the difference between rich and poor to reach uncontrollable limits so as to disturb the peace of society. Although it does not believe in forceful equality in possession of economic means in the way socialist theory has postulated, it does stand for socio-economic justice. It believes in fair and equitable distribution of incomes and wealth, and calls for the state should provide for basic human needs to all of its citizens.

1.3.2 Features of the Islamic economic system

In many ways, an Islamic economic system is a construct that either harks back to the golden era of Islam in the time of the Prophet and the early caliphs, or envisions a futuristic utopia. Most Muslim countries do not currently implement an Islamic economic system, although countries like Pakistan, Bangladesh and Sudan have vowed to Islamise their economies.

Islamic economists have nevertheless drawn up a number of key elements for an Islamic economic system, which are based on:

- The real economy and wealth creation

  The Islamic economic system places emphasis on producing goods and providing services. Assets produced, bought, sold and shared should bring value to the community. This stands in contrast to money markets in conventional finance. This is not to say that trade, even on the financial markets, in itself is not allowed, but it is subject to a number of ethical requirements stipulated in Islamic commercial law.

- **Money as a potential capital**

  Linked to the emphasis on the 'real economy' is the Islamic definition of money.

  Money is the main form of exchange all over the world. This came about as a solution to a need that people had: how to trade and exchange goods and services in a fair and effective way. With the introduction of money came the need for intermediaries to manage excess liquidity from some to insufficient liquidity of others. Through deposits (excess liquidity), banks built monetary reserves allowing them enough capital to fund and finance commercial projects. To fund themselves, banks in return were paid added interest on the loan. Money according to conventional mainstream is therefore a commodity: banks sell money as their commodity. This is similar to a trader in the market who sells his products to prospective buyers at a mark-up: the banks sell money to their clients.

  In contrast, Islam considers money as a medium of exchange and means to an end. Unlike conventional finance, Islam does not consider money as a commodity and therefore, money, strictly speaking, must not be traded.

- **Circulation of wealth and allocation of resources**

  Hoarding of wealth by the few is regarded by Islamic economists as an impediment to economic growth as it restricts the capacity of individuals without to fully attain their potential. Instead, circulation of wealth among all the sections of society is encouraged. Zakat (alms-tax), a mechanism that is covered later, acts particularly as a retributive wealth tax.

  The Islamic economy does not forbid private property, there is a Trustee contract. However, it is recognised that market mechanisms are not sufficient to create and maintain social justice. To encourage human brotherhood and the welfare and socio-economic justice of all people, moral principles across the various building blocks of society are imposed on all blocks of society.

- **Equitable distribution and redistribution of wealth**

  Distribution of wealth by human beings must include care of different groups. Islamic inheritance laws are an interesting case as a person can only bequeath in a will up to one-third of his/her property whereas for those close relatives such as spouses and children who remain outside the list of inheritors, a predetermined share has been specified in the Qur'an.

- **Principle of Moderation**

  Islamic economics is about managing resources with moderation and in line with the ethical teachings of the Shari'a. This is particularly telling because the word *Iqtisad* used in Arabic for 'economics' is originated from the same word that also means moderation. The opposite of *Iqtisad* is *Israf* which is often translated as 'extravagance' or 'over-indulgence'. Israf is condemned in many verses in the Qur'an:

  > *"…and do not squander wastefully, surely the squanderers are the followers of the devils and the devil is ever ungrateful to his Lord." (Qur'an 17:26-27)*

  Therefore in an Islamic economic system many legal and economic measures have been provided to bridge the gap between the rich and the poor and to establish a welfare state which guarantees provision of social security and secures basic needs to its less fortunate citizens. These aspects of Islamic economy we shall study in subsequent chapters of this unit. Here we can safely conclude that Islam believes not in equal distribution but in an equitable and just distribution of resources and wealth.

1.3.3 Features of Islamic Finance

The basic principles and practices of Islamic finance date back to the early part of the seventh century when Muslim societies started with the provision of financial services in line with the Shari'a,

Islamic or Shari'a-compliant Finance
Islamic finance refers to the provision of financial services in line with the Shari'a.

What is the objective of Islamic economics and finance?

Islamic finance is comprised of financial transactions that are not contradictory to the objectives of Islamic law. Whilst modern Islamic banking arose in the 1980s, the idea of Islamic economics reaches back much further. Islamic economics is about the principles for establishing and operating an economy where the behavioural norms and moral foundations are derived from the Shari'a.

Objectives of the Shari'a

A number of scholars have advanced "objectives", "goals" or "purposes" they believe the Shari'a is intended to achieve – referred to in Arabic as ***Maqaṣid al-Shari'a***. The famous medieval Islamic philosopher Abu Hamid Al-Ghazali (1058 - 1111), also known as *Algazelus* or *Algazel* to the Western medieval world, argued that these objectives were the preservation of:

- Faith (*Deen*)
- Life (*Nafs*)
- Lineage / Progeny (*Nasl*)

- Intellect (*'Aql*)
- Property / Wealth (*Mal*)

The implications of the Shari'a's objective to preserve or protect the wealth of its citizens are an important driver in the development of Islamic finance.

Contemporary scholars such as Laldin & Furqani (2013) have attempted to elaborate on the objective of wealth (*Mal*) within the context of financial transactions and banking and postulate five objectives:

1. Continuity of the circulation of the wealth,
2. Continuity of the investment of wealth,
3. Achieving comprehensive communal prosperity,
4. Financial transparency and
5. Validation of financial ownership.

The focus on this *Maqasid* also emphasises that Islamic economics and finance constitute not only guidelines for managing a good economy, stimulating growth and development, but have the capacity to realise socio-economic justice as implied in the objectives of *Shari'a.*

Islamic economics as a third way

Therefore advocates of **Islamic economics** generally describe it as neither socialist nor capitalist, but as a "third way", a potential 'ideal' model with none of the drawbacks of the other two systems. Among the claims made for an Islamic economic system by Islamic economists and revivalists are that the gap between the rich and the poor will be reduced and prosperity of all enhanced by such means as the discouraging of the hoarding of wealth through taxing idle wealth with the alms-tax *Zakat*. In the financial sector an emphasis is put on exposing lenders to risk through profit sharing and venture capital, the prohibition of speculation/gambling and other activities considered sinful by Islam, such as the production of alcohol.

Ethical Foundations

Money is not an earning asset

Islamic finance is founded on the core belief that money is not an earning asset in and of itself. In addition, there are some general principles that are of particular importance for Islamic, or perhaps more precisely termed "*Shari'a* compliant", finance and these include:

- Interest is forbidden in that it is a predetermined, fixed sum owed to the financier irrespective of the outcome of the business venture in which the capital is used. This does not imply in any way that the provision of money is in all circumstances free of charge or that it should be made available without any cost or that there should be absolutely no return on capital. Rather, a return on capital is allowed, provided that capital participates in the productive process and is exposed to business risk.
- The specifications, existence and ownership of the product or service that is bought or sold must be clear to both parties and the remuneration for such product should be agreed where this will typically include the price and payment terms.

- A financial transaction needs to have a “material finality”, that is, it should be directly or indirectly linked to a real, tangible economic activity as opposed to financial speculation.
- There should be no funding of Haram (sinful) activities such as the production of alcoholic beverages or gambling, and funds should preferably finance socially productive activity. In broad terms, Islam forbids all forms of economic activity which is morally or socially harmful.
- There must be some risk exposure to the underlying activity to legitimise the profit, whether funds are used in a commercial or productive venture.
- A financial transaction should not lead to the exploitation of any party in the transaction.

Islamic banks and financial institutions have been set up and this has become an alternative mode in many countries.

Based on the above, a general common objective of Islamic finance is to support the development of the economy according to the ethical principles of Islamic law which include both prohibitions such as of interest and also the encouragement of positive social behaviour such as honesty and fairness in Islamic finance contracts.

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1.4 Exercises

Chapter 1 – Exercises
Your tasks: Read Chaudhry, Muhammad Sharif. "Fundamentals of Islamic economic system."*Burhan Education and Welfare Trust* (1999). ▪ What are the 10 salient features mentioned of an Islamic economic system? ▪ Discuss what are the implications of the concept of God's vice- regent for the poor? *Solutions: Please refer to the last chapter.*