Islamic finance: No fee?

Islamic finance is known primarily for the prohibition against interest. Does this ban mean that savings cannot be rewarded and that no fee is charged to customers taking out loans? Or does Islamic finance simply involve the use of alternative schemes by financial institutions that, while complying with Islamic laws and regulations, nevertheless have the same functions as those of conventional financial institutions? Is the prohibition against interest the only feature of Islamic finance that differs from its conventional counterpart? This Special Report describes the fundamentals of Islamic finance and briefly outlines its development.

What is Islamic finance?

The basis of conventional finance is that lenders (such as banks) receive a previously agreed fee from borrowers in exchange for the funds they provide (this is known as 'interest'). Within this system, risks are insured or transferred to the extent possible. Islamic finance, however, is based on different principles, arising from Islamic laws and regulations (known as Sharia). It is a finance system that is based on different ideas about 'money brokerage' than conventional finance systems. For example, money cannot be traded as a commodity. The main principle of Sharia observed in Islamic finance is justice in a social and – in particular – an economic sense. [1] For example, risk and profit must be shared. The main Sharia principles that form the basis for Islamic finance include:

Interest prohibition versus trade and risk sharing

The most well-known principle is the prohibition against interest (known as *riba*).[2] Under Islamic law, charging and paying interest is banned, being regarded as one of the Major Sins. One of the purposes of the ban is to protect the less fortunate in society from exploitation. Other objectives are justice and honesty in trade. The prohibition encourages investors and labourers to invest their riches together in joint ventures rather than lending them out in order to make a profit (Saleh 1992). Under Sharia, trade is regarded as the legitimate way to earn money and is contrasted with the prohibition against interest. The ideal model in Islamic finance is, therefore, for the lender to share in the entrepreneurial risk. On this basis, a number of different finance schemes have been created (see elsewhere in this document). The conventional financial system distinguishes between acceptable interest rates and exorbitant interest rates (usury). However, almost all Islamic scholars hold that no such distinction is made under Islamic law, and that no interest rate is permitted whatsoever (Talal 2007, El-Gamal 2003). Money is regarded as a medium of exchange without any inherent value, which must not be traded (Saeed 1996). This means that any monetary return on money is prohibited. Note that the prohibition against interest does not only play a role in Islam, but also in Judaism and, until the sixteenth century, in Christianity.[3]

Prohibition of gambling and unnecessary risk

Lesser-known Islamic prohibitions are those of gambling (*maysir*) and taking unnecessary risk

[1] One example of justice in the social sense is that Sharia incites people to grant extensions to debtors in distress, and it is considered even better if the debt is cancelled.

[2] 'Interest' is not a direct translation of the term *riba*, but due to the limited scope of this article the two terms are used interchangeably. Note that not all forms of *riba* fall under the definition of the current Western term 'interest', as there are different forms of *riba*. There is also the fact that – under certain circumstances – a sale with a mark up in exchange for deferment of payment is not inconsistent with Sharia. Although the increase might be interpreted as Western interest, it is not subject to the prohibition against *riba* (for more information, see Talal 2007).

[3] For more information, please see: Visser 2009 and other publications.

or avoidable uncertainty (*gharar*). Like interest, gambling is regarded as one of the Major Sins under Islamic law. One of the consequences of this law is a prohibition against speculation. The condition of the second prohibition is that the object and price of a transaction must be clearly described (El-Gamal 2001, Visser 2009). *Gharar* is a common feature of conventional finance, particularly in derivatives trading and insurance. In conventional insurance, a premium is paid in exchange for a consideration that is uncertain. In order to ensure that Muslims can obtain insurance under the rules of Islam, an Islamic form of insurance has been created (known as *takaful*). *Takaful* is based on brotherhood, solidarity and cooperation between the various parties. It might be described as a pact between a group of individuals (participants) who insure each other against financial losses or claims that might affect any of them. Rather than consisting of premiums, as with regular insurance, contributions to the *takaful* fund are made in the form of voluntary payments (El-Gamal 2006).

Unlawful under Islam

Furthermore, investing in products and activities that are objectionable under Islam, including pork, alcohol, gambling and prostitution, is prohibited. This includes companies trading in items that violate Sharia, such as conventional financial institutions (Visser 2009).

Islamic contract law

Islamic financial transactions must not be in violation of Islamic contract law, which establishes the conditions for the legitimacy and contents of a contract. The primary conditions for the contents of the contract include: 1) the subject of the contract must be permitted under Islamic law; 2) the object at hand must be well defined, and there must be no *gharar*; 3) the object must exist;[4] 4) only one transaction is permitted under a contract. (Thomas *et al.* 2005, Visser 2009).

Mandatory Sharia Board

How do consumers know if the products offered by an Islamic financial institution actually comply with the rules? Who monitors this? Any institution offering Islamic financial products must have what is known as a ‘Sharia Board’ in place. This board has a supervisory and advisory role and must ensure that all activities are performed in accordance with Islamic laws and regulations. The board’s recommendations are binding. A Sharia Board must consist of at least three specialized Islamic scholars, while the number of members must always be uneven in order to facilitate voting.

Separate entity

Finance in accordance with the above-mentioned principles is offered both by Islamic financial institutions and by conventional ones. How can conventional financial institutions offer Islamic financial products without combining it with interest or other practices prohibited under Islam? The solution conceived for this purpose is that a separate legal entity must be established, known as an ‘Islamic window’. This separate entity must operate highly independently from the parent bank and must focus exclusively on Islamic finance. This means that not only the loan in the last link of the chain, but also the entire money flow must comply with Islamic law.

Islamic finance schemes

In compliance with the above-mentioned principles and prohibitions, a number of schemes have been created over time in order to structure Islamic financial products. With some exceptions, these forms can be categorised into three main groups (Iqbal & Llewellyn 2002),

[4] With the exception of a number of contract types, such as *bai' salam*, i.e. a contract where advance payment is made for goods to be delivered at a later date. However, it is unclear whether the object of the sale, such as harvest, will exist in the future. This type of contract was already permitted at the beginning of Islam, due to the public interest (*maslaha*) involved. The agricultural sector, for example, would suffer immensely if this form of buyer’s credit were not permitted.

namely methods based on:

1) profit-sharing or profit-and-loss sharing

These contracts, which are classified as ventures or partnerships, are known as *musharaka* and *mudharaba* schemes. These forms are from an ideological point of view considered as the preferred structure within Islamic finance. However, in reality they are not used as frequently as other forms. This is because the risks involved are greater and because some forms of finance, such as consumer loans, are not suitable for these schemes;

2) a fixed profit mark-up

These are known as 'exchange contracts' or 'mark-up contracts' (*murabaha*).These contracts provide for the actual sale of goods, rather than money being exchanged for an interest-bearing debt. The financier buys the goods the consumer intends to purchase and then sells them on to the consumer at a profitable mark-up;

3) Leasing or rent

These forms are highly similar to the conventional concept of operational leasing (*ijara*) and financial leasing (hire-purchase) (*ijara waqtina'*).

All prevalent forms of Islamic finance are in some way asset backed: there must be an underlying asset, given that money itself should not be the object of trade. As with conventional financial schemes, these schemes are designed to make a profit, the notable difference being that this must be consistent with Islamic law. Various schemes are used within the entire Islamic financial market, although how they are used may differ by institution and by region. Financial products offered in Islamic finance are still being developed, and many aspects have not yet been fully fleshed out. The Islamic financial market continues to face many challenges, which will be addressed in a future Special Report.

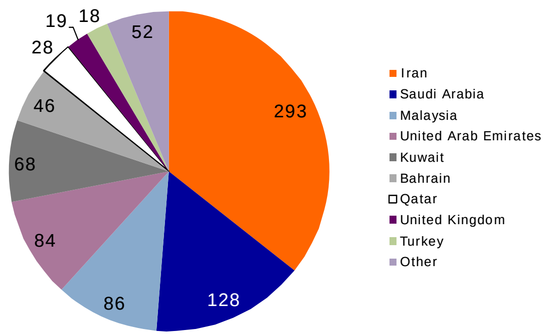
The emergence and rapid growth of the Islamic financial market

The theory of Islamic finance as we know it today was conceived in the early twentieth century. It was presented as an alternative to the interest-based Western banking system, which, as a result of Western colonisation, had been introduced in Islamic countries (Saeed 1996, Visser 2009).

The Islamic financial market only truly came into its own several decades later. Islamic finance is currently one of the fastest-growing segments in the financial sector (Standard & Poor's 2010). The market has developed rapidly since the establishment of the first Islamic banks around 1970. Although the market accounts for only around 1% of total assets worldwide, it has grown at an annual rate of 15 to 30% since 2000 (Rung *et al*. 2011, el Qorchi 2005). The sector appears to be less affected by the financial crisis than the rest of the financial market (Standard & Poor's 2010, Alasrag 2010). Due to, among other factors, the presence of a sizeable Muslim population and the concomitant demand for Islamic financial products, Islamic finance has grown in both Islamic countries and Western countries such as the United Kingdom and the United States. The French government is currently considering whether (and, if applicable, what) legislative changes should be implemented in order to facilitate Islamic finance in France. Various other European countries, including Malta and Italy, have shown an interest in this market as well (Standard & Poor's 2010).

Figure 1: Geographic distribution of Islamic finance

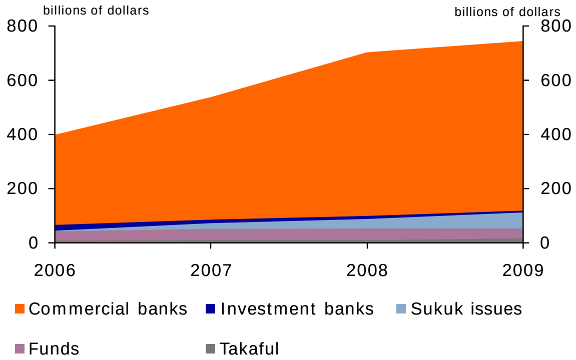
billions of dollars – position at year-end 2008



Source: The Banker

The current Islamic financial market consists mainly of Islamic banking, along with Islamic funds, insurance (*takaful*), investment banks and investment certificates (*sukuk*) (see Figure 2).

Figure 2: Global assets in Islamic finance



Source: Islamic Finance 2010, IFSL Research.

Conclusion

Islamic finance encompasses more than a prohibition against interest; it is a form of finance based on a set of principles arising from Islamic law and regulations. A number of schemes have been created based on these principles for the structuring of Islamic financial products. Fees are permitted within this system, as long as they are consistent with Islamic law. Islamic financial transactions must be asset backed and aimed primarily at risk sharing. This is in contrast to conventional finance, which uses interest and is based mainly on debt relationships, risk minimisation and risk transfer. A relatively young niche market, the Islamic financial market emerged several decades ago and has developed at a fairly rapid pace. However, there are a number of aspects that need to be further developed before the market can be regarded as mature. These issues will be further addressed in a future Special Report.

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