Islamic Finance- A Practical Guide

A Review by Alexis Lescott

Introduction
“Islamic Finance” is a compilation of essays from several banking and legal professionals in the field of Islamic finance, and edited by Rahail Ali a partner at Lovell’s, an international law firm. It provides a comprehensive insight into how conventional financial products have been restructured to accommodate Islamic investors, outlining the processes and maintenance involved in making financial products Shariah compliant.

The book is specifically geared towards professionals in finance, asset and risk management, insurance, and researchers and developers seeking to study or establish Islamic financial structures or products. Anyone wishing to understand the structure of the financial products available within Islamic finance or seeking a career in Islamic finance will find the text useful as it details how products like sukuk (bonds), project finance, insurance, and equity funds work within the realm of Islam.

Islamic finance is part of a larger unified system known as Islamic Economics and is one of the world’s fastest growing areas in finance. Prior to the late 1990’s there was much uncertainty among Muslims as to whether investing in shares or equity instruments were permissible under the laws of Islam. In response to increased capital flows due to a growing demand for petroleum in the oil-rich nations, an integrated financial and banking system was created to allow Islamic followers who wanted to invest their funds in accordance with Islam, an opportunity to do so.

The book is generally easy to read but is, in some respects, repetitive, as the first few authors give the same details about what is prohibited from investment and the acceptable levels of non-Shariah activities. It is a fairly technical text as it details the actual processes in the various contracts which is probably aimed at giving details to institutions seeking to create Islamic products or investors seeking to understand the intricate workings of the financial products available under Shariah.

Islamic finance is an extremely interesting topic and should be of special interest to economists and investors alike, especially in the face of rising oil prices, which will tend to strengthen Islamic markets and products. Islamic financial institutions can provide a source of alternative investment for businesses and private individuals seeking to diversify their investment portfolios.
Islamic Financial Products - An Overview

Islamic laws, as outlined in the Shariah, are a set of principles that govern the life of an Islamic believer. Shariah specifically prohibits activities such as interest and gambling thus banks and financial institutions seeking to tap into the wealth of Muslims had to develop products and services, which did not conflict with their religious beliefs. The authors have outlined some of the major financial products and services used to facilitate Islamic investing, detailing the processes involved in establishing and maintaining Shariah compliance.

Contrary to prima facie notions surrounding usury, Shariah encourages trade and investment on the basis of profit-sharing ventures or partnerships to earn lawful returns, as opposed to using fixed returns or interest-based activities. The underlying principle of Shariah is to create an equitable environment for financial institutions and customers alike. Shariah compliance can be very complex as it seeks to outline and monitor the rights and responsibilities of the buyer and seller, while protecting the sanctity of the laws of Islam. Islamic financial institutions are, however, not operated as charities but are accountable to their shareholders for acceptable rates of return on capital and investments. In light of this, the assessment of return on risk-adjusted capital and the pricing or yield determination process as well as the process of assessing a corporation’s credit rating is the same as in Western capital markets.

There are five main Shariah compliant leverage structures that provide the basis for investment in any financial instrument in Islamic finance. These include: (1) the ijara- a lease for assets such as real estate, ships, aircrafts, and the like; (2) musharaka- a joint venture arrangement; (3) mudaraba- a type of trust financing over which a mudarib (manager) is appointed; (4) murabaha- a contract sale where an intermediary purchases a commodity from a supplier and sells it to an end user, at a price plus a profit margin; and (5) an istisna- which involves a sale contract where an item is to be produced in accordance with agreed specifications at a determined price for a fixed date of delivery (e.g. manufacturing, construction, assembling or packaging).

The screening methodology criteria provides guidelines on screening companies conducting non-Shariah compliant business activities and excludes those companies whose financials do not meet the minimum acceptable levels. The screening methodology criteria was formulated in 1987, and provides Islamic investors the opportunity to own shares of listed joint stock companies, however these criteria are standard, regardless of the type of investment being undertaken.

The structure of the financial products, as outlined in the text, are almost identical to conventional ones, but for the restrictions as outlined by the screening methodology criteria and the Shariah advisory council or board which must be
appointed by Islamic financial institutions to monitor and screen the activities of companies listed as Shariah-compliant.

Certain companies and assets are discouraged rather than prohibited under Islamic law, but those strictly prohibited and thus not qualified for investment under Islamic finance are:

- alcohol;
- entertainment (hotels, gambling (including casinos), cinemas/movie theatres, music, pornography);
- weapons and defense;
- tobacco;
- conventional financial services (e.g. banking, insurance, etc.);
- pork related products;
- biotechnology companies involved in human/animal genetic engineering;
- and,
- any other sectors determined by the Shariah committee from time to time.

Additionally, when a company is involved in non-Shariah activities, as is common with most conventional methods and business, the mudarib must apply the rules of Shariah in determining the minimum acceptable level of leverage, receivables, and interest income. Any income received from investing in prohibited business is deducted from payment of profit or dividends- a process that is referred to as purification in Islamic finance. The general rule is that any income that is gained from prohibited activities must be donated to charity.

The Islamic investment funds industry has grown since the development of the Shariah screening criteria. Shariah-compliant investment funds have given Islamic investors access to several regional and international stock markets and several index providers have launched Shariah-compliant versions of their main index. Some of these indexes include:

- Dow Jones Islamic Market Indexes
- S&P Shariah Indexes
- FTSE Global Islamic Indexes
- Bursa Malaysia Shariah Index
- Global GCC Islamic Index
- MSCI Islamic Index Series

Each index has its own benchmark for Shariah-compliant securities listed. They all enlist Shariah boards or advisory firms which create and enforce Shariah screening criteria. They review the activities, procedures, and assets of the fund periodically to ascertain compliance. The Shariah board’s input is required at the structuring of the fund and monitoring of the investments occurs on an ongoing basis.
In keeping with the laws prohibiting usury under Islam, money cannot be sold except at its nominal face value. Goods and services provided must be sold at cost plus the mark-up, which reflects the seller’s profit. At the time of sale goods must exist, have value and belong to the seller.

Sukuk is what conventional finance refers to as a bond, where asset trust certificates are issued to investors. In contrast to bonds, the investors’ returns represent the right to receive monies on financial indebtedness, while with sukuk the investors’ returns are derived from legal or beneficial ownership of assets as opposed to interest-based debt obligations.

Both the private and public sectors issue sukuk. Some popular sukuk issues include the 2007 Dar-Al Arkan Real Estate Development Company’s US$1 billion sukuk in Bahrain, the 2006 Free Zone Corporation sukuk issued in United Arab Emirates amounting to US$3.5 billion and the Government of Pakistan US$600 million issue in 2005.

The major challenge in the sukuk markets is the limited degree of transparency. The Middle East is known for their tradition of secrecy, based on selective dissemination of information. Zaidi (2008) recommends cultural change to facilitate the growth of capital markets. Another problem facing investors is inadequate international credit ratings in the region, although an increasing number of institutions are realizing the importance of ratings and are thus seeking to become familiar with the process.

Kawaf and Miller (2008) are of the view that the recent expansion in Islamic finance has centered on debt-based Islamic financial markets, which behave very similar to conventional equivalents. Debt-based financing is not deemed Shariah-compliant thus there has been a shift towards areas of business that are viewed as more Shariah-based, namely: private equity, venture capital, and investment funds, due mainly to their approach to risk-taking.

Trade finance is another area which has been embraced by Islamic finance. Trade finance can be either domestic or international and is used in conjunction with letters of credit or other documentary credits. A murabaha is the main mechanism used for trade financing in Islamic finance and can be used for import or export financing facilities. It requires careful preparation of documents, which must be approved by a Shariah supervisory board.

The Qur’an, however, endorses project financing since it ultimately provides utilities and services (e.g. water plants, roads, power stations, etc) for the wider good of the community. However, traditional Islamic financing products were not suited to the long repayment tenors associated with project finance or the size of
the financing requirements of recent projects such as Rabigh, and Islamic banks were not able to provide financing for projects in excess of US$1 billion. Coupled with this was the misconception that Islamic funds could not be utilized in conjunction with conventional financing. However, developments over the last few years as well as openness on the part of Islamic scholars to accommodate innovative structuring, have dispelled the notion that Islamic funds could not be used in multi-sourced financing that included a conventional tranche.

Project financing is also available under Islamic finance and has three main products. Unlike conventional methods, there is a direct relationship between the financiers and the project company via an istisna agreement. The other two agreements are musharaka (joint venturing) and wakala (agency). All responsibilities relating to the project execution, supervision, and completion are borne by the project company as agent under the agreement. There are laws in keeping with Islam, governing termination of a contract, liquidation, taxes, and procedures to be followed during the operating phase of the completed project.

With respect to insurance, most Shariah scholars oppose the practice of selling insurance (especially life insurance) and have not identified alternatives to all the policies available under conventional insurance schemes. Billah (2008) suggests that this is an area that contemporary scholars can be innovative and therefore derive an alternative Islamic model.

Thus development of Islamic finance is ongoing and some activities that were once deemed prohibited are constantly reassessed to keep pace with the expanding financial needs of Muslims. An example is the sale of a debt (bai'-al-dain). This is generally prohibited under Islamic law but some Malaysian scholars issued a fatwa permitting the sale of debt.

A major concern raised as it relates to Islamic finance is whether the Islamic model is more equitable and sustainable than the conventional finance model. Opponents are of the view that Islamic products share the same risk-and-reward profile as conventional products, only differing in their form and structure. To this end, they do not view one as materially different from the other and conclude that Islamic products may invariably end up with the same challenges facing conventional markets.

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1 Rabigh is located in Saudi Arabia and is a project involving the construction of an integrated petroleum refining complex, as well as an upgrade to existing infrastructure. Overall financing amounted to US$5.84 billion inclusive of an Islamic tranche of US$600 million.

2 A fatwa is a legal verdict or pronouncement based on Islamic jurisprudence which is usually given by a Shariah scholar or a Shariah board.
On the other hand, reference has been drawn to the kosher kitchen of the Jews in the United States that caters to the religious needs of the Jews. It has been argued that although it may be less cost effective and efficient, it does meet the religious and emotional needs of the Jews and cannot be classified as more or less superior to the conventional kitchen. Therefore, the Islamic financial model may very well be less competitive in pricing and efficiency but more importantly it appeals to the religious needs of Muslims. Thus it should not be viewed as superior or inferior to the prevailing conventional financial model, but should be promoted as merely a religious based system.

Other proponents are of the view that the economic impacts of Islamic financial products should be left to the regulators (such as Central Banks) and pressure groups (like consumer associations). Still others believe that the onus lies with the providers of Islamic financial solutions to ensure that products and services meet the needs of the consumers while achieving the higher objectives of Shariah.

**Conclusion**

Islamic financial products, services, and institutions have been rapidly expanding over the past thirty years to cater to the exponential growth of Muslim investors wanting to manage their investments in accordance with their faith. The Islamic financial market has become very sophisticated and offers products and services ranging from personal to corporate finance. Some of the products available include home financing, Islamic fee-based credit cards, structured bonds, convertibles, exchangeables, equities, alternative assets, project finance, private equity, and the list is expanding rapidly. Technological advances have also made available services such as online, and telephone banking.

Ideally, the aim of Islamic finance is to attract the business of Muslims who are still banking and investing with conventional institutions, as well as non-Muslim investors, seeking to diversify their portfolios or expand their investment base. With additional products and services being structured to facilitate Islamic investors, there is the hope of providing a substitute for all conventional financial products and services as well as fulfilling the higher objectives of Shariah. This aim is considered realistic, and includes achieving equitable distribution through profit-and-loss-sharing, reducing over-reliance on debt, promoting a culture of "save now and buy later", and creating a balanced society that finds an alternative to consumerism.

The aim of Shariah in prohibiting usury is an equitable concept, from which conventional financial institutions could adopt certain aspects, especially in times of global economic challenges. Drawing from an example cited in the text, financial institutions could look at charging loan interest based on the cash flows of businesses or individuals rather than fixed rates, since the later approach does not
cater to off-seasons or periods of slow cash inflows. This may require some structural and cultural adjustments, cost assessments, and feasibility studies.

Although the general understanding of Islamic finance is still very basic and practitioners, consumers, regulators, and economists are still grappling with the new phenomenon, it has been recommended by Haneef (2008) that Islamic financiers collaborate with Islamic economists in an effort to transmit their thoughts and experiences to better understand the way forward for the industry. This must be coupled with the insight of Shariah scholars to ensure that the design and implementation of Islamic financial products meet the objectives of Shariah.

Islamic finance is an interesting area for research in the Caribbean in relation to the feasibility of establishing and maintaining Islamic financial institutions or products, to accommodate the relatively large Islamic populations of Trinidad and Guyana, as well as attracting foreign investors from the oil-rich Middle East nations.