

# Islamic Finance

“This book is a great addition to the growing literature on Islamic banking and finance. The chapters are sequenced well, beginning with a good introduction and followed by a discussion on the philosophy and basic principles of Islamic banking before embarking on the legal requirements of contracts and deposits. The authors then expound how these contracts are translated into practice by the contemporary Islamic banking industry and also compare the Islamic products with the prevailing conventional banking products. The book also covers the recent trends in technology and governance and complimenting markets like sukuk, takaful and wealth management. This book will be immensely useful for students of Islamic banking, as well as practitioners, academics, regulators and policy makers.”

—Rafe Haneef, *CEO and Executive Director-CIMB Islamic Bank*

“This is an important book not just for students of Islamic finance but also for banking practitioners and consumers of banking products as it sets out the fundamental differences between Islamic finance and conventional banking and its importance in promoting a conscionable financial practice and sustainable economic development.”

—Raja Teh Maimunah, *CEO, AmInvestment Bank*

Nafis Alam • Lokesh Gupta  
Bala Shanmugam

# Islamic Finance

A Practical Perspective

palgrave  
macmillan

Nafis Alam  
University of Reading Malaysia  
Johor Bahru, Malaysia

Lokesh Gupta  
RM Applications  
Kuala Lumpur, Malaysia

Bala Shanmugam  
Federation University Malaysia  
Petaling Jaya, Malaysia

ISBN 978-3-319-66558-0      ISBN 978-3-319-66559-7 (eBook)  
<https://doi.org/10.1007/978-3-319-66559-7>

Library of Congress Control Number: 2017951020

© The Editor(s) (if applicable) and The Author(s) 2017

This work is subject to copyright. All rights are solely and exclusively licensed by the Publisher, whether the whole or part of the material is concerned, specifically the rights of translation, reprinting, reuse of illustrations, recitation, broadcasting, reproduction on microfilms or in any other physical way, and transmission or information storage and retrieval, electronic adaptation, computer software, or by similar or dissimilar methodology now known or hereafter developed.

The use of general descriptive names, registered names, trademarks, service marks, etc. in this publication does not imply, even in the absence of a specific statement, that such names are exempt from the relevant protective laws and regulations and therefore free for general use.

The publisher, the authors and the editors are safe to assume that the advice and information in this book are believed to be true and accurate at the date of publication. Neither the publisher nor the authors or the editors give a warranty, express or implied, with respect to the material contained herein or for any errors or omissions that may have been made. The publisher remains neutral with regard to jurisdictional claims in published maps and institutional affiliations.

Cover designed by Jenny Yong  
Cover illustration: © BornaMir / Getty Images

Printed on acid-free paper

This Palgrave Macmillan imprint is published by Springer Nature  
The registered company is Springer International Publishing AG  
The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

# Foreword

Islamic banking and finance has emerged as a viable alternate finance stream and has lately gained a reputation as a full-fledged academic discipline knocking on doors of universities worldwide. Consequently there have been numerous books on the topic, but most of them are written exclusively for practitioners or for students only. This has inadvertently created a gap for readers who seek to comprehend both the theoretical underpinning and its applicability in the real world. *Islamic Finance- A Practical Perspective* provides a complete guide for the understanding of the theory and practices of Islamic finance. The book also highlights Islamic banking's suitability and its position in the world of finance.

By including chapters such as Information Technology in Islamic Banks and Islamic Wealth Management, the book provides another dimension of Islamic finance, which has not gained extensive support from researchers in this field. The use of simplistic language and day-to-day examples would assist readers in understanding key concepts easily.

The authors have also provided behind-the-scenes calculations done by Islamic banks for easy referencing when it comes to understanding the mechanics of profit loss sharing and financing charges.

The book will act as a good guide for students in both undergraduate and postgraduate programs in Islamic banking and finance, as well as Islamic banking practitioners and banking and finance researchers.

I wish to congratulate the authors for their exhaustive research and fluent exposition and wish the readers happy reading.

Asia e University  
Kuala Lumpur, Malaysia

Prof. Dato' Dr Ansary Ahmed

# Preface

Islamic banking as an industry has seen phenomenal growth since its rebirth in recent times, posting constant double-digit growth. It has not only transcended in Muslim world but has captured the attention of Western countries and global financial bodies such as World Bank and the International Monetary Fund. Many international banks now offer Sharia-compliant products and services, calling it ‘Interest-free Banking’, ‘Socially Responsible Banking’ or even ‘Ethical Banking’—but the primary motive is to offer banking services with a big ‘NO’ to interest.

In these modern materialistic times, ethics and social objectives often take a back seat, but Islamic banking is one service where social motives and society welfare has been prioritized. This book is an attempt to create awareness of Islamic banking principles, and the development of its products and services by employing the profit computation method. While we wrote the book keeping bankers in mind, all concepts are presented in a simple and concise manner for easy comprehension.

We have tried to address the common questions about Islamic banking: What is Islamic banking? How is it different from conventional banking? How do Islamic banks generate profit? Is profit a substitute for interest in Islamic banking? How are Islamic banking products structured and applied for different banking needs? Why do Islamic banking practices differ from country to country? What is the role of information

technology in Islamic banks and how can it leverage on Fintech? What kind of Corporate Governance model is practised by Islamic banks?

We wish to extend our appreciation to friends and family for their encouragement, patience and moral support. Special thanks to our banker friends who shared with us practical aspects of Islamic banking and to our publisher for their unending patience.

This book is our small contribution to society. We would be pleased to hear comments and constructive criticism from readers. While this book is the outcome of comprehensive research, errors nevertheless will exist, and for those we ask for your forgiveness.

Selangor, Malaysia

Nafis Alam

Kuala Lumpur, Malaysia

Lokesh Gupta

Petaling Jaya, Malaysia

Bala Shanmugam

The original version of this book was revised. Preface and Foreword are added to the front matter of this book.

# Contents

<b>1</b>	<b>Introduction to Islamic Banking</b>	<b>1</b>
<b>2</b>	<b>The Religious Foundations of Islamic Banking</b>	<b>17</b>
<b>3</b>	<b>Prohibition of Riba and Gharar in Islamic Banking</b>	<b>35</b>
<b>4</b>	<b>Islamic Contracts</b>	<b>55</b>
<b>5</b>	<b>Islamic Deposits in Practice</b>	<b>79</b>
<b>6</b>	<b>Islamic Financing in Practice</b>	<b>131</b>
<b>7</b>	<b>Comparative Analysis: Islamic Banking Products and Services in Different Countries</b>	<b>245</b>
<b>8</b>	<b>IT in Islamic Banks</b>	<b>307</b>
<b>9</b>	<b>Corporate Governance in Islamic Banks</b>	<b>359</b>

<b>xii</b>	<b>Contents</b>	
<b>10</b>	<b>Islamic Capital Market</b>	<b>397</b>
<b>11</b>	<b>Takaful</b>	<b>431</b>
<b>12</b>	<b>Islamic Wealth Management</b>	<b>451</b>
	<b>Index</b>	<b>475</b>

# List of Figures

Fig. 1.1	Historical developments in Islamic banking. Source: Author view	8
Fig. 2.1	Three Islamic faith foundations. Adapted from Haron and Shanmugam (2001)	18
Fig. 2.2	The Five Pillars of Islam	22
Fig. 2.3	Syariah overview	24
Fig. 2.4	Sources of Syariah	25
Fig. 2.5	Banking and finance needs of Muslims and non-Muslims. Source: Adapted from Khan (2007)	32
Fig. 3.1	Riba excesses	37
Fig. 3.2	Types of Riba	38
Fig. 3.3	Riba Qardh	39
Fig. 3.4	Riba Jahiliyyah	39
Fig. 3.5	Riba Fadhl	40
Fig. 3.6	Riba Nasiah	41
Fig. 3.7	Basis of Ribawi material	43
Fig. 3.8	Types of gharar	51
Fig. 4.1	Classification of contract according to nature of contract	60
Fig. 4.2	Classification of contract according to legal consequences	62
Fig. 4.3	Valid sale contract	69
Fig. 4.4	Islamic banking contracts	74
Fig. 5.1	Al-wadiah classification	84
Fig. 5.2	Mudharabah	86

**xiv List of Figures**

Fig. 5.3	Saving Account based on the wadiah yad dhamanah principle	87
Fig. 5.4	Investment account based on the Mudharabah principle	103
Fig. 6.1	House Financing using BBA	138
Fig. 6.2	The modus operandi of umrah financing by using BBA	140
Fig. 6.3	Modus operandi of cash line financing by using BBA concept	142
Fig. 6.4	Instalment schedule inclusive of GPP	149
Fig. 6.5	<i>Modus operandi</i> of Murabahah financing	156
Fig. 6.6	Modus operandi of Murabahah financing for working capital	158
Fig. 6.7	<i>Modus operandi</i> of Ijarah financing	169
Fig. 6.8	<i>Modus operandi</i> of AITAB financing	179
Fig. 6.9	Musharakah classification. Source: Saiful Azhar Rosly (2005), “Critical Issues on Islamic Banking and Financial Market”	190
Fig. 6.10	<i>Modus operandi</i> of Musharakah financing	195
Fig. 6.11	<i>Modus operandi</i> of diminishing Musharakah for house financing	202
Fig. 6.12	<i>Modus operandi</i> of bai salam financing	221
Fig. 6.13	Structuring an Istisna financing transaction	224
Fig. 6.14	Bai al Inah financing mechanism	233
Fig. 8.1	Various key subsystems in core banking system	311
Fig. 10.1	Components of the ICM	399
Fig. 10.2	Working structure of Islamic unit trusts/mutual funds	408
Fig. 10.3	Structure of Sukuk Ijarah	419
Fig. 10.4	Illustration of a Sukuk mudarabah	420
Fig. 10.5	Sukuk Musharakah	422
Fig. 11.1	Comparison between Takaful and conventional insurance system	436
Fig. 11.2	Mudharabah model	437
Fig. 11.3	Wakalah model. Note: The surplus can also be shared with Takaful operators, as it depends on how the model is structured. The Wakalah model is the most recognized and accepted in the international Takaful market comprising 30 countries	439
Fig. 11.4	Wakalah with Waqf model	441
Fig. 12.1	Number of Islamic funds domiciled by country as on March 2017	466
Fig. 12.2	Global Islamic assets under management (AUM) by domicile as of Mar 2017. Source: <a href="http://www.mifc.com">www.mifc.com</a>	466

# List of Tables

Table 1.1	Differences between Islamic banking and conventional banking systems	12
Table 3.1	Rule matrix for ribawi materials	45
Table 3.2	Riba and profit	46
Table 5.1	Saving Account types	88
Table 5.2	Saving Account profit computation with 5% hibah rate	91
Table 5.3	Wadiah current account practice	94
Table 5.4	Mudharabah current account profit computation	100
Table 5.5	Mudharabah current account profit computation, dividend	101
Table 5.6	Mudharabah muthalaqah practice (general investment account)	105
Table 5.7	Mudharabah muthalaqah dividend computation	108
Table 5.8	Mudharabah Muqayyadah elements	110
Table 5.9	Mudharabah Muqayyadah (special investment account)	111
Table 5.10	Types of accounts offered by Islamic banks	128
Table 5.11	Types of deposit accounts	129
Table 6.1	Essential elements of BBA contract	135
Table 6.2	BBA financing practice	143
Table 6.3	Computation formula	146
Table 6.4	BBA financing instalment computation using Rule 78	150
Table 6.5	Murabahah financing practice	160
Table 6.6	Murabahah Financing Computation	161

**xvi**      **List of Tables**

Table 6.7	Comparison between BBA and Murabahah practice in Malaysia	166
Table 6.8	Essential elements of Ijarah contract	171
Table 6.9	Common features of product offered by banks	174
Table 6.10	Ijarah financing computation	175
Table 6.11	Comparison between Ijarah and conventional leasing	176
Table 6.12	Essential elements of AITAB	181
Table 6.13	AITAB financing computation	182
Table 6.14	Comparison between AIAB and conventional hire purchase	189
Table 6.15	Essential elements of Musharakah contract	193
Table 6.16	Diminishing Musharakah financing computation	204
Table 6.17	Shareholding	207
Table 6.18	Comparison between diminishing Musharakah and BBA financing	217
Table 6.19	Essential elements of bai salam contract	219
Table 7.1	Terminologies in practice for Islamic banking in ASEAN region	261
Table 7.2	Comparison of functions and principles	271
Table 7.3	Comparison of Islamic current account facilities	273
Table 7.4	Comparison of Islamic Saving Account facilities	274
Table 7.5	Comparison of Islamic investment facilities	279
Table 7.6	Comparison of Murabahah financing product	282
Table 7.7	Comparison of BBA financing products	286
Table 7.8	Comparison of Musharakah financing products	291
Table 7.9	Financial disclosure of Islamic banks of different countries	302
Table 8.1	Software companies currently providing Islamic banking solutions	347
Table 11.1	Number of Takaful operators/Takaful windows globally by category (2014)	445