Islamic Finance

Abul Hassan · Sabur Mollah

Islamic Finance

Ethical Underpinnings, Products, and Institutions

palgrave
macmillan

Abul Hassan
King Fahd University of Petroleum
and Minerals
Dhahran, Saudi Arabia

Sabur Mollah
Accounting and Finance
Swansea University
Swansea, South Glamorgan, UK

ISBN 978-3-319-91294-3 ISBN 978-3-319-91295-0 (eBook)
https://doi.org/10.1007/978-3-319-91295-0

Library of Congress Control Number: 2018942351

Cover credit: jackof, iStock/Getty Images Plus
Cover design by Thomas Howey

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

Preface

Concept of Islamic finance has been considered as a financial system in consonance with the ethos and value system of Islam. Therefore, it is governed, in addition to the mainstream system of good governance and risk management rules, by the principles laid down by the Shari'ah (Islamic laws). Based on its core Islamic ethical values, Islamic financial system has often been compared with the theme of ethical finance, corporate social responsibility and socially responsible investment. A supplementary component, however, escorts the value proposition of Islamic financial system, the religious factor. The foundation of the Islamic ethical paradigm is in fact founded on *'adl* and *qist* (justice and equity); a second element is *amanah* (trust) and a third is *Ihsan* (benevolence) which establish the socially responsible apparition and objectives of the Islamic Financial Services industry. Therefore, essence of Islamic financial requires all financial products to be structured and implemented in compliance with Shari'ah and has offered a unique customer base tempting opportunity to conduct business according to Islamic ethics. Indeed, facts show that Islamic finance does not only appeal to Muslims but also to non-Muslims equally.

The goals of Islamic financial systems are often stated in socially laudable terms such as promotion of economic well-being, poverty alleviation, fulfilment of basic human needs, optimization in the utilization of natural resources, fulfilment of spiritual needs and promotion of universal brotherhood and economic and social justice. Within the Islamic worldview, the Shari'ah is believed to set the guidelines on all aspects of human life. As such Shari'ah compliance is considered a prerequisite requirement of the fulfilment of economic and financial transactions within the Islamic believe—whether at the individual, societal, institutional and governmental levels. To achieve this means, Shari'ah stipulates and advises people to adopt permissible and productive activities (*halal*) to promote public interest (*maslahah*) and reject prohibitive and harmful activities (*haram*) to prevent harm. Further, with Islamic finance model, all the stakeholders whether investors, customers, savers, borrowers, buyers, sellers, employees, management and traders are attributed a socially responsibly role. The expectation is that Islamic faith, which instils a concern for the Hereafter (*akhira*), will influence an individuals' level of personal motivation such that people behave altruistically and pursue their self-interest within the bounds of social interest. Therefore, unlike the individual who is guided by self-interest under the *homo-economicus* principles in neoclassical economic literature, the individual guided by the norms of Islam would exhibit altruism, humanism and social responsibility. Indeed, individuals within Islamic norms are accordingly given the special name of *homo-islamicus* in the Islamic economic literature.

On the other hand, Islamic epistemological notions of "human accountability before God," "man's role as vicegerent (*Caliph*) on earth" and "promotion of socio-economic justice" are further assumed to be the drivers which restrain self-interest, motivate individual to make careful use of limited resources belong to God, care for the environment and fulfil their social obligations. Hence, individual within the Islamic norm is also expected to be socially responsible with respect to their finances. Islamic investors are concerned with not just what kinds of activities are being financed but also the way they are funded. They would seek the deployment of funds in lawful (*halal*) way. This search for Shari'ah permissibility in one's decisions contributed to putting market pressure on businesses to produce and market lawful (*halal*) products. Within the financial arena, it sets the basis for the development of the Islamic Financial Services industry.

Islamic Finance Prohibits *Riba*, *Gharar* (Uncertainty) and *Mysir* (Gambling)

Socially responsible goals of the Islamic financial system are based on some prohibition and encouragements. The prohibition of *Riba* (interest) and permission to trade, as enshrined in the Al-Quran (2:275), says: "God has allowed profit from trade and prohibited *Riba*," derive the financial activities in an Islamic economy towards asset-backed business and transactions. This implies that all financial transactions must be representative of real transaction or the sale of goods, services or benefits. Islam also has prescribed a moral standard that is almost common in all civilized societies of the world. The structure of Islamic finance revolves around the prohibition of any return derived on a debt (*Riba*) and legality of profit. *Riba* is an increase taken as a premium from the debtor. It represents the return on transactions involving exchange of money for money or an addition, on account of delay in payment, to agreed price on sale of loan/debts. The Shari'ah has prohibited it as it generates imbalances in the economy. As all transactions involving interest payments are strictly prohibited. So debt contacts cannot be sold at a premium or discount, and exchange tractions of money or goods resenting money like gold and silver must be equal for equal and hand to hand. While the term "equal for equal" is obviously, meaning that any increase in one side would be *Riba*, the exchange of money as business must also be hand to hand, because otherwise, a person can take benefit by the use of money which he or she has received while he or she has not given its counter value from which the other party could take benefit.

Second prohibition is *Gharar* (uncertainty). In compliance with the principles of Islamic ethics, Islamic finance avoids *Gharar* (uncertainty). *Gharar* refers to entering into a contract in absolute risk or uncertainty about the ultimate results of the contract and the nature and specification of the subject matter or the rights and obligations of parties. *Gharar* is also involved if there is a lack of adequate value-relevant information or there are inadequacy and inaccuracy of any vital information which leads to uncertainty and exploitation of any of the parties. Dishonesty, fraud or deliberate withholding of value-relevant information is tantamount to *Gharar*. Islamic Financial Institutions (IFIs) should not engage in any bargain in which the results are hidden, as they would not be certain whether the delivery could or would be made, which is necessary for the completion of any genuine business transaction. The contemporary practices of conventional financial institutions and insurance companies in the futures and options markets are not Shari'ah compliant because of the elements of *Gharar*, interest, gambling, etc. The transaction of current stock markets, if cleansed of these elements, would be termed as Shari'ah-compliant stock market.

Third kind of activity which IFIs have to avoid is gambling (*mysir*). Gambling is involved in a number of financial transactions and conventional banks' products, which IFIs have to avoid. Conventional insurance is not Shari'ah compliant due to the involvement of both *Riba* and *mysir* (gambling). Governments, public- and private-sector corporations mobilize resources on the basis of lotteries and draws which come under the hammer of gambling and are, therefore, prohibited in Islamic financial system. Current futures and options contracts that are settled through price differences only are covered under gambling. Similarly, a scheme wherein the money of investors is safe and intact but the prizes to be given are related to interest generated from capital accumulated through it, does not conform the Shari'ah due to involvement of both *Riba* (interest) and gambling.

Signposts of Islamic Finance Development

Today, Islamic finance has been developing so vigorously that it has evolved from a nascent industry in a global market, where Muslims and other non-Muslim communities are working together and learning from each other for the development of relevant products and services. It has passed the significant milestones of existence, recognition by the global financial regulators and central banks and most recently in delivery of sophisticated and lucrative financial services with competitive pricing and sufficient care of Shari'ah compliance. All of this was achieved within just 35 years. Until early 1970, Islamic banking and finance was an academic dream of which a few people were aware, even educated Muslims, now it has become a widely known practical reality. It has made headway in 1985 as a new system of financial intermediation, in spite of an unfavourable environment and without the help of the auxiliary or shared institutions needed for its successful operation. It recognition around the world relates to its workability and viability.

Islamic finance has also attracted the attention of mega international financial institutions, regulators like Federal Reserve Board, Financial Services Authority of UK, IMF and the World Bank and prestigious academic centres of higher learning like Harvard University, John Hopkins University and MIT in the USA; and London School of Economics, Durham University, Aston University and Oxford University in UK; and all most all Universities in Middle East and South East Asia. Islamic finance is being experienced in over 80 countries around the world, with about 500 IFIs in the field. A number of international institutions and regional financial centres are playing a crucial role in the standardization of Islamic finance products and this enhancing its credibility.

It may specially be mentioned here that almost all multinational conventional financial institutions and their subsidiaries are offering Islamic financial products through Islamic windows or full-fledged subsidiaries. Indeed, it is strong sign of good and ethical business in future that will increase the prosperity and peace of mind of millions of people who were earlier either keeping away from the conventional banking and financial system or feeling guilty due to the association of interest in their transactions, which is forbidden at least in the three monolithic religions (Judaism, Christianity and Islam). This has provided a paradigm shift for financial services by installing a moral compass for the banking and financial system based on Islamic ethics and by linking them with the real economy.

Islamic finance standard-setting bodies and global facilitators like Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions, Islamic International Rating Agency (IIRA) and the International Liquidity Management Centre (ILMC) are proving reorganization for Islamic finance and enhancing its credibility to both customers and regulators. Middle Eastern countries like Bahrain, Saudi Arabia, Kuwait, Qatar and South East Asian Countries like Brunei, Malaysia and Indonesia have been serving hub of Islamic finance for about three decades. Currently, cities like London, Luxembourg and Singapore are also striving to serve centres for Islamic finance.

Demand for Islamic finance is on the rise both in Muslim countries and in non-Muslim countries. In the Britain for example, there are 6 full-fledged Islamic banks and 18 conventional banks are providing Islamic products. In UK, more than 10% customers of Islamic Financial Services are non-Muslims. In Malaysia, about 38% customers of Islamic banks are non-Muslim. In North America, a large number of institutions are proving Islamic Financial Services mainly to the Muslim community. No doubt, the projections in Islamic finance for the future are expected to be better, particularly if the volatility prevails in the international financial system and continues to highlight like credit crunch/financial crisis from time to time and lead to apprehension that it cannot be removed by making cosmetic changes in the conventional financial system but rather by injecting into the system greater market discipline. It may be noted that this discipline is deep-rooted in the principles of Islamic finance.

Rationale for the Book

Indeed, there is a destitute concern to enlighten stakeholders, such as the students, academics, general public and financial intuitional personnel about Islamic finance. Further, those particularly interested are students of business, and finance who intend to study or take up a career in the growing Islamic banking and finance industry. As Islamic financial products introduced in this emerging industry, all stakeholders should know that what Islamic finance is and what its products and institutions. They should understand the ethical foundation of Islamic finance, the application of the principles of the Shari'ah in Islamic banking and finance instruments, markets, products and their salient features and legal positions and functions, the mechanism of CSR, Shari'ah-compliant corporate governance, risk management and BASEL accord applicable in Islamic banking and finance industry. Unfortunately, despite the relevance of these components of Islamic finance, which remain unclear to most stakeholders, there exist only a few reference sources and acquaint them with the theory and practice of Islamic finance. This book related to one part of the agenda prescribed above and this pondering upon its ethical underpinning, products, markets and institutions. Further, the Shari'ah principles, accounting, CSR, corporate governance and other performance standards as being developed by the standard-setting bodies like the AAOIFI and IFSB are based on the mainstream view and interpretation of the Shairah.

The policy makers, bankers, the business community, industrialist, Shari'ah scholars, students of the universities and general public at large need to know what Islamic finance is, what is its philosophy and features and how it works. This book is an attempt to simplify and explain in clear terms. In particular, the product developers, those responsible for implementation as well as financial experts, need to be familiar with the essential requirements of Islamic ethical norms in products, services, CSR, governance and risk management.

Organization of the Book

The nature, scope and objectives and main moral features of Islamic finance are discussed briefly, just to lay a foundation for the discussion which studying and understanding the Islamic financial system. Main body of the book is devoted in explaining moral foundation in its products, markets and its operation, and institutions. Due attentions are given to regulatory, supervisory and governance issues that are relevant to Islamic finance industry. The book comprises two parts, each part spanning a number of chapters.

Part I (Chapters 1–14): The first part of the book provides discussion on Islamic finance and its ethical underpinning, Islamic financial markets and their different products, portfolio performance and Islamic finance customer loyalty. Brief details of the break-up each chapter in the Part I are:

Chapter 1: This chapter devoted some important concept on the inter-relationships between ethics and economics and finance in Islam. Largely, it is stated that ethics establish endogenous portents in Islamic economics and finance.

Chapter 2: A discussion about Islamic finance would not be complete if the historical overview of its development has not been provided. This historical perspective is provided about the Islamic financial markets, value propositions and their growth.

Chapter 3: Shareholders, employees and management form the first priority group of the stakeholders of an Islamic bank. Whereas traditional stakeholder theory fails to explain because of its non-moral approach, Islam explicitly asserts that the introduction of moral reasoning may contribute to an organization's effectiveness rather than undermine it.

Chapter 4: The Islamic ethical investment industry claims that while assessing a company's social and environmental record, a better insight into an organization's financial performance can be gained. The two models in this chapter demonstrate that the use of Islamic ethical criteria in the selection of a portfolio of shares could have a variety of positive and negative effects upon investment performance. The combination of all these factors may have the overall effect of broadly similar financial performance to conventional funds.

Chapter 5: As customers in the banking industry are becoming more demanding and increasingly mobile between competing financial providers, simply being customer-focussed is not enough. Since customers are the driving force of Islamic Financial Institutions, hence customers' satisfaction is a very important aspect in the competitive market. This chapter emphasized that Islamic Financial Institutions need to take seriously their products marketing aspect in consonance with Islamic business ethics.

Chapter 6: This chapter scrutinizes the causes of the contemporary financial crisis and assess the notions that drive to the very core of capitalism that may have the potential to cause such crisis. It assesses several issues that have also backed to the economic disaster. The Islamic interpretation of such factors is offered to show how an Islamic economic and banking system might help to carry the stability that the world desires seriously.

Chapter 7: This chapter primarily deliberates the characteristics of Islamic equities and the financial instruments which are used in the Islamic equity markets.

Chapter 8: While the development of Sukuk originated from the idea of finding an alternative to interest-bearing bonds, today with the rising Shari'ah concerns about the Sukuk structures, emphasis is being placed by *fiqi* (Islamic jurisprudence) councils to ensure that Sukuk structuring aligns closely with the principles of the Shari'ah. This chapter demarcates clearly the differences between Sukuk and conventional bonds in terms of the structure, design, utilization of proceeds and overall objective of supporting genuine activities and economic development.

Chapter 9: Islamic mutual funds provide opportunity to small investors, who do not have access to capital market, to participate in the economic development of the country. It is simply a mechanism for diverting extra funds available with the public to the Islamic capital market. This chapter focused main feature of the Islamic mutual fund that it allows diversification of portfolio for the small investors who may not be able to do so due to lack of financial knowledge.

Chapter 10: In the field of Islamic corporate finance, private equity provides an attractive outlet for *Musharakah*-based investments in institutional Islamic funds, culminating in an increasing trend of Islamic banks getting involved in private equity deals by setting up their own private equity funds. The chapter discusses about the untapped market for private equity in the Muslim world in general and the Middle East in particular. Since most of the Middle Eastern big individual investors and Islamic banks have had excess liquidity over the recent year, therefore, the importance of private equity in the region has been gradually realized.

Chapter 11: In this chapter, the instruments like financial futures (stock index futures), option and warrant are examined in Islamic perspectives. It also explained the impediments to structure these instruments as part of Islamic capital market instruments and suggested the ways to overcome the obstacles.

Chapter 12: The main aim of this chapter is two fold: firstly, it checks the relationship between Islamic microfinance and the socio-economic welfare of women, and secondly, to explore the perspective in which Islamic microfinance packages function and the system of their performance how can be enhanced. The main results show that growth in women's revenue and resources played an important role in improving women's financial freedom and sense of self-possession.

Chapter 13: This chapter focused on the popularity of Shari'ah-compliant mortgages is being reflected in the greater range of products, which will assist in building customer confidence in the Islamic mortgage market. It seems that the UK is now leading Europe in the development of Islamic finance products in general and Shari'ah-compliant mortgages in particular.

Chapter 14: This chapter covers the basic conceptual framework of takaful and re-takaful and their operational framework.

Part II (Chapters 15–25): This part focused on the regulation, risk management, CSR of Islamic Financial Services, accounting, governance and their international Islamic infrastructure institutions.

Chapter 15: Shari'ah is best characterized as moral guidance or a set of principles governing all aspects of the day-to-day activities of Muslims. The tradition of Shari'ah laws has a long history, but implementation of Shari'ah law in modern commercial activities in general, and particularly in the contemporary financial system, is at the developing stage. While several leading Islamic financial centres around the world have adopted IFSB and AAOIFI standards, but much needs to be done to standardize Islamic financial products and regulation at the international level.

Chapter 16: This chapter describes that there is need for unified international best practices and prudential standards for supervision and regulation of Islamic banking to ensure a legal framework for the functioning and supervision, adequate risk management, disclosure of information and corporate governance in Islamic banks and financial institutions.

Chapter 17: This chapter discusses risk involved and how to deal with these risks within the Shari'ah framework and risk management tools and mechanism available in the IFIs.

Chapter 18: This chapter elaborates on the risk management in IFIs with an empirical fieldwork by analysing the implications of the Basel III Accord to Islamic Banks in the light of IFSB guidelines.

Chapter 19: This chapter focused on CSR as a framework in which businesses align their core values with the expectations and needs of their stakeholders. The developments of CSR in IFIs sector should drive the Islamic Financial Services industry towards greater financial and Shari'ah discipline, sophistication and integration with the international financial markets.

Chapter 20: The chapter argued that Islamic accounting for Islamic finance ensures compliance with Islamic objectivity which fulfils the *Maqasid al Shari'ah* (goal of Islamic law). By setting clear objectives for financial accounting of Islamic financial system and institutions, it helps to make sensible judgements for choice among alternative accounting treatments.

Chapter 21: This chapter devoted to explain the principles of Islamic accounting which is grounded in principles of fairness, justice and equity between parties—as well as a fundamental sharing of risk and profit of investment.

Chapter 22: Corporate governance has gained momentum in recent years, due to uniqueness to their nature, Islamic banking and financial system is subject to additional layers of governance, since the suitability of its investment and financing must be in strict conformity with Islamic business ethics and the expectations of customers. Therefore, corporate and Shari'ah governance are the main concern of this chapter.

Chapters 23–25: Islamic Financial Services industry has been a number of international Islamic infrastructure institutions established to support its global development. These chapters provide overview of the formation of Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFIs), Islamic Financial Services Board (IFSB), Islamic International Rating Agency (IIRA) and International Islamic Liquidly Management Corporation (IILM).

Dhahran, Saudi Arabia Abul Hassan
Swansea, UK Sabur Mollah

Acknowledgements

All along, we have benefited from writings, discussion, correspondence and personal interaction with various scholars and economists, and no amount of gratitude will suffice; acknowledging them individually will be an impossible task and we beg forgiveness from all those who have helped during the writing of this book but whose names have been failed to be mentioned due to lack of space. However, there are a few who have helped with great sympathy by providing their expert opinion and suggestions in particular, to mention, Professor Khurshid Ahmad, former Chairman of the Islamic Foundation, UK, and Dr. Umer Chapra, Advisor to the President of the Islamic Development Bank (IDB), Jeddah (Saudi Arabia).

Much beholden to Dr. Abdullah Almansour, Director, and to all the colleagues especially Sultan al Rashedi at the Centre of Research Excellence for Islamic Banking and Finance, King Fahd University of Petroleum and Minerals, Dhahran, for being a constant source of encouragement in this endeavour. We would like to put on record our special thanks and appreciation for Professor Dr. Sahel N. Abduljauwad, Vice Rector (Research), King Fahd University of Petroleum and Minerals, Dhahran, Saudi Arabia, for encoring me to produce the manuscript of this book.

We would like to thank two anonymous book reviewers for their valuable and constructive comments which enhanced the flow of the book contents significantly. We would also like to thank Ms Tula Weis, Senior

Editor of Palgrave Macmillan, the publisher of this book for her suggestions and constant reminder to complete the book on time.

At the end of the day, we take full responsibility for its contents. We are grateful to Allah Almighty for guiding us in every stage of life and seeking his forgiveness for any errors and shortcomings.

On behalf of the book project

King Fahd University of Petroleum and Minerals
Dhahran, Saudi Arabia

Abul Hassan

Contents

List of Figures

List of Tables