CHAPTER 1

The Islamic Finance Space

As a historical religion, Islam has been in existence for 1,400 years. The word *religion* comes from the Latin word *religio*, which means to bind oneself.[1] Religious principles bind mankind to a way of life that is meant to be pleasing to God. Human history provides enough evidence that mankind has not always followed religious principles in their true spirit and has had to pay the consequences from time to time.

Finance has been around as long as man has inhabited this earth. The most basic form of finance in prehistory was money lending and remains so today. All the Semitic religions of Christianity, Judaism, and Islam warn mankind against the practice of usury, which allows interest to be the reward for money lent. Islam is not the only religion to forbid the taking of interest. The word used in the Quran is *riba*,[2] and has been interpreted by scholars as taking of any excess money from a borrower when a loan is repaid. A loan is specifically defined as a contract whereby one party lends money to another party for a specific period of time, for example, borrowing $1,000 for 90 days and repaying $1,200.

Finance was also an integral part of the Muslim empires of the Ummayads, the Abbasids, the Fatimids, the Mamlukes, the Seljuks, and also of

[1]Wilfred Cantwell Smith, *The Meaning and End of Religion* (Minneapolis: Fortress Press, 1991 edition).

[2]Verses from the Quran regarding the prohibition of *riba*:

30:39: "The usury that is practiced to increase some people's wealth, does not gain anything at God. But if you give to charity, seeking God's pleasure, these are the ones who receive their reward many fold."

4:161: "And for practicing usury (interest), which was forbidden, and for consuming the people's money illicitly, We have prepared for the disbelievers among them painful retribution."

3:130: "O you who believe, you shall not take usury (interest), compounded over and over. Observe God that you may succeed."

the Ottomans. Islam dawned on Arab traders (most previous Prophets were either craftsmen or farmers). The Prophet ([saw] peace be upon him) himself was a trader. Trade has such an importance on the fabric of Islam that the Quran itself endorses trade or *bai*.[3]

What kind of trade did Islam permit? Certainly Islam permitted certain trade practices and forbade others, like hoarding of goods,[4] inflating prices by meeting merchants outside city walls and buying their goods before they come to market,[5] or selling goods not in one's ownership.[6] These obligations had an impact on the trading practices endorsed within the Muslim world. Principles of fairness, keeping one's oath, fulfilling terms of contracts were endorsed not just in conversation but in the Quran itself.[7]

Much of the Muslim world remained an agriculture-based economy, with a monarchical political system of rule. The Muslim world is famous for its *bazaars*, where traders came from across the globe to trade wares and to be exposed to this new religion that had shown its face on the pages of history. Although much of Orientalist literature[8] focuses on the military conquests of the Muslim rulers, little is talked about of the impact of trade with the Muslim world, or the institutions of trade. Scholars such as Donald Quateart are working on archives found in the libraries of Istanbul to give a more clear picture of what life was like in the most recent episode of Islamic history, that of the Ottoman Empire.

In an empire as vast as the Ottoman Empire with Istanbul being the center of trade for much of the civilized world, trade and finance must have

[3]Legality found in the Quran, surah Al-Baqarah verse 275, "However, God permits commerce, and prohibits usury (interest)."

[4]This is mentioned in the Quran, chapter 3, verse 180: "Let not those who withhold and hoard God's provisions think that this is good for them; it is bad for them. For on the Day of Resurrection they will carry their hoardings around their neck"; and also in a hadith, which narrates the saying of Prophet (saw): "Nobody hoards except the wrongdoer." Al-Qazveeni, Muhammad bin yazeed, sunanibn-e-maajah, Berut: Dar-ul-fikr, 1999, H:2153.

[5]Abu Huraira (Allah [sat] be pleased with him) reported the Prophet (saw) as saying: "Do not meet the merchant in the way and enter into business transaction with him, and whoever meets him and buys from him that when the owner of the goods comes into the market, he has the option to declare the transaction null and void."

[6]Muslims are prohibited in selling goods before possessing them. The Prophet (saw) mentioned, "Whoever buys cereals shall not tell them until he has obtained their possession."

[7]The Holy Quran, 17:34, "Come not nigh to the orphan's property except to improve it, until he attains the age of full strength; and fulfil (every) engagement, for (every) engagement will be enquired into (on the Day of Reckoning)."

[8]Edward Said, *Orientalism* (New York: Pantheon Books, 1978).

gone hand in hand. There is no evidence of the existence of modern-day banks in Istanbul; certainly, however, the oldest banks and banking families belonged to Italy and lived in the 1500s. There is also no concrete evidence of cooperatives, or benevolent funds that could be the prototype of modern-day insurance. We would have to wait until the libraries of Istanbul reveal these secrets to come to any conclusion.

However, with vast stores of grain coming from different parts of the Empire where different currencies were employed it is not difficult to imagine that some informal structures of commodity exchanges must have existed, some mechanisms must have been developed to hedge risks of price volatility, and some mechanisms must have existed to raise capital and borrow capital. Development comes in times of peace, and unless one were to buy Kinross's version of Ottoman history, the Empire offered its citizens a period of respite for close to 500 years. Media headlines tend to focus on atrocities alone, but that is another matter. Another element of genius within the fabric of the Empire was that Christians, Jews, Indian Muslims, Arab Muslims, Italians, and Venetians alike were allowed to serve the Empire and to develop trade, commerce, and institutions of law in a manner not seen at any other phase of at least Islamic history. Humans, whether Muslims or non-Muslims, must have developed innovative commercial contracts, mechanisms of trade, financial products, and even derivatives over a period of time within the boundaries of the Empire. It is no surprise therefore that the first formal codification of commercial law is found in the *Mejelle*, which was a Hanafi document developed in the seventeenth and eighteenth centuries within the Ottoman Empire.[9]

So, how far back does Islamic finance go? One can say the contracts of sale of *murbahah, bai al inah, bai al wafa, bai al dayn*, or *bai al sarf* even predate Islam. Islam just eliminated certain features of these contracts and retained others depending on whether certain features contradicted any legal maxims. The application of these sale contracts to financial intermediation in a fractional reserve system is far more recent and can be first seen in the 1970s in places like Egypt, Sudan, Iran, and other pockets of the Muslim world.[10]

However, one must note that the past 200 years for every Muslim country has been one of colonial domination, with many countries gaining formal political independence in the latter half of the previous century, and all after World War II. As such, almost all Muslim countries have inherited

[9]David P. Forsythe, *Encyclopedia of Human Rights*, vol. 1 (New York: Oxford University Press, 2009).
[10]Natalie Schoon, "Islamic Finance—A history," *Finance Services Review*, 2009.

legal systems from the times of their colonial rulers, and other institutions of rule, government, and commerce. We must not forget that much of the Muslim world did not experience the Industrial Revolution in the manner that Europe and the United States did, nor could many wonderful inventions and advancements in the sciences be attributed to a Muslim world that still predominantly had pockets of agricultural economies and trade-based economies. The Muslim world also inherited a dollar-based and an interest-based global financial system.

The need for oil in the twentieth century put the Muslim world into prominence again with much of the natural resource being found under the sands of the ancient cities that were once home to peoples of prehistory.

It is also important to keep in mind that the Muslim world is divided in its interpretations of the religion and in the social structure of their societies, with certain countries adopting monarchies, or constitutional monarchies, and others adopting a democratic form of government. Military dictatorships have been common in the Muslim world until the recent demise of such figures as Saddam Hussein and Qaddafi. Iran has a unique theocratic form of government, where religious clerics are key stakeholders in the running of the government. Some Muslim countries have a large percentage of non-Muslims as their citizens as well. All these factors influence not only the exchange of ideas within the Muslim world but also the development of any consensus of issues of importance within the sphere of political and commercial life. Needless to say there is need for convergence and unity among the Muslim countries in their understanding of the religion and in coordinating efforts to serve the needs of close to 1.3 billion Muslims across the globe.

MODERN PHASE OF ISLAMIC FINANCE

The modern phase of Islamic finance may have been the brainchild of political ideologists that saw the post–World War II world economic system built on the principles of interest. Efforts were made to develop in theory and in practice an economic and a financial system that did not depend on *riba*, but any such attempt could only meet with limited success when the currencies of each Muslim country were pegged to the U.S. dollar. The U.S. dollar system is based on interest. Had the Muslim world adopted a more isolationist attitude to international trade the results may have be different, and ironically two economies, China and India, that during the 1970s and 1980s had turned their back on international trade are now leading exporters on the global economic stage.

Nevertheless, the Muslim world developed institutions to collaborate, the first of its kind being the Islamic Development Bank (IDB), which possibly embodies the aspirations of many Muslims in fulfilling the goals of a

Muslim society.[11] The IDB is unique in that its capital is provided by its member states, which are Muslim countries, and it funds projects related to infrastructure development, poverty alleviation, access to education, and clean water and such. The IDB is dedicated to providing funding on a sustainable basis to various segments of the Muslim world to improve the well-being of the *ummah* in general. One may think of it as a world bank for Muslim countries. The existence of IDB created a unique problem of providing funds to member countries not on an interest basis but on *shariah*-compliant basis, and it is likely that within the halls of IDB meetings the first financial products were developed.

Institutions such as Accounting and Auditing for Islamic Financial Institutions sprang up when the idea of offering *shariah*-compliant financial products took germ as a commercially viable proposition for the private sector to adopt. Since 1971, when IDB was set up, other countries, like Pakistan, Malaysia, and Indonesia, also took the mandate to move their financial systems away from a *riba*-based structure to a more *shariah*-compliant alternative. *Shariah* advisors were placed within central banks and other regulating bodies to come up with a framework for "Islamic Banking and Islamic Insurance." No other country took this task more seriously than Malaysia, which saw it as an opportunity to become a global hub for Islamic finance. Malaysia is surrounded by some of the major financial and business capitals of the world, such as Shanghai, Singapore, Hong Kong, and Tokyo, cities that are destinations of billions of dollars of foreign direct investment and international capital flows. Malaysia saw an opportunity to be the routing point for the flow of capital within the Muslim world and made great strides in making necessary changes in its regulatory system by acts of Parliament, changes in its taxation system and its legal system to bring Islamic finance in the mainstream of financial transactions. Capital markets were restructured and a methodology of *shariah* screening of asset classes was developed. The first *shariah*-compliant index was proposed in Kuala Lumpur.

The Malaysian government funded research institutions to develop the infrastructure of Islamic banking products and also to set up training institutes to train its own bankers and those around the world in what it believed was a viable alternative to conventional banking and insurance.

Bank Negara Malaysia, Securities Commission Malaysia, soon to be followed by Bank Indonesia, and Securities Commission Indonesia made formal announcements of issuing licenses to Islamic Banks, *takaful* companies, and Islamic asset management companies, and slowly the rest of the Muslim world followed.

[11]Islamic Development Bank, www.isdb.org, accessed June 26, 2014.

Malaysia followed a prudent approach to developing Islamic banks allowing existing banks to first begin with Islamic windows. Windows operations offered customers *shariah*-compliant asset and liability products as part of a conventional banks framework. The window operation functioned with its own balance sheet, but shared the infrastructure of the conventional bank to save on costs. The Islamic banking window had to have a team of *shariah* advisors to endorse products and processes. These products had to be approved by a *shariah* board placed at the central bank. The window operation was phased into subsidiaries, which had to maintain separate economic capital and report separate financial statements. Foreign banks were given the leniency to maintain Islamic banking divisions where a limited product menu was on offer, and capital only had to be lien marked in the bank's balance sheet to fund the assets of the Islamic banking business.

Similarly, changes were made to the capital markets and rules were developed for screening asset classes and for offering *shariah*-compliant securities and products on the stock exchange. A *shariah* board at the securities commission was put in place to regulate the issuance and sale of *shariah*-compliant capital market instruments such as *sukuk*. Malaysia masterfully maintains a dual-banking system in which conventional banks and Islamic banks operate simultaneously.

Undoubtedly, Malaysia enjoyed the position of being a thought leader in the sphere of Islamic finance and generously shared its understanding of *shariah*-compliant products and principles not only with the rest of the Muslim world but with the non-Muslim world as well. Institutions such as J.P. Morgan, Citibank, Barclays, and HSBC all have Islamic banking divisions catering to either investment banking or wealth management. HSBC offers the brand of HSBC Amanah and Standard Chartered took pains to develop the brand of Standard Chartered Sadiq. International rating agencies such as Moody's and Standard & Poor's have worked with industry professionals and developed mechanisms of rating *shariah*-compliant institutions and financial instruments. International fund managers and hedge funds now have in place methodologies of screening asset classes for *shariah*-compliance for their clients. Dow Jones has in fact developed a *shariah* index for all the major indices it develops, including FTSE 100 and Nikkei 225 index, the BRIC index, and the GCC index, thus facilitating *shariah*-minded investors in guiding their capital in a manner that fulfills certain *shariah* guidelines. In post–September 11 times, for financial institutions to adopt the word *shariah* in their brochures is quite an achievement.

These are no minor achievements to say the least, but has Islamic banking provided a viable alternative to conventional banking? As many architects of Islamic banking were likely attached to the Islamic Development Bank, there is also a strain of disillusionment that Islamic banking has gone astray, or gone commercial. IDB was and is a public policy institute funded not by shareholders but by governments. Its aim is to fund projects and make a nominal return on the financing provided. The technology of Islamic banking was transferred to the commercial sector, and to compare an Islamic bank driven by the aims of maximizing returns to the IDB is like comparing J.P. Morgan to the World Bank. Both entities exist for different purposes. One can argue that there are not enough Islamic micro-finance banks, or Islamic venture capital firms, or Islamic SME fund houses, but that is not the fault of the concept of Islamic banking. Capital providers or investors must see the light and allocate capital to such enterprises; academics and scholars cannot do so.

Islamic financial institutions therefore offer financial products using *shariah*-compliant contracts. The "impact" of these products is the same on a client or an investor, in that if an Islamic bank facilitates the purchase of a new car, the beneficiary of the purchase must pay the bank back with profit. There is no free lunch. IFIs rely on the same model of financial intermediation that conventional banks, insurance companies, and asset management companies do, and that is the "pooling of funds." Islamic banks collect funds from customers using *shariah*-compliant contracts, and use these funds to finance assets or make investments. The capital of the Islamic bank is not used to fund assets, but is used as a buffer to cushion losses. All profits generated are shared with depositors. Conventional banks absorb losses in entirety, whereas Islamic banks in some circumstances pass on losses to their customers.

Takaful companies also pool in funds of participants. Participants contract to contribute to a pool of funds that will be used to indemnify the participants if they suffer losses from specific events. Participants do not buy insurance policies from insurance companies; they seek to protect themselves and each other against adverse events. In practice no participant in a *takaful* plan knows any other participant, so such claims may only be interpreted as being cosmetic. *Takaful* operators are then hired to manage the underwriting process for a fee.

Fund managers also work on a contract of agency or *wakalah* and are compensated by investors for above-market performance by healthy commissions like in conventional firms. The road thus far shows the Islamic financial services industry converging toward the conventional industry and many critics feel this does not in any way fulfill any broader goals of Islam. Critics have a point, but we leave it up to the readers to determine that during the course of reading this book.

The Islamic financial services industry is built around 16 or so fundamental contracts. We first study these contracts and then later see how they are reengineered or modified to develop financial products. The criticism of the modifications is left up to the reader.