ACCA

Parliamentary Briefing

Islamic Finance

What is Islamic finance?

'Islamic finance' is a term used to describe financial transactions that are compliant with the principles of 'Shari'ah' (Islamic law). Based on interpretations from the Qur'an and relevant religious literature, it works on the principle that finance providers and their customers should treat each other in an honest and ethical manner. Indeed, it is vital to the reputation and future success of an Islamic financial institution that it is seen to be abiding by this principle.

Although the concept of Islamic finance is almost as old as the religion itself, modern Islamic finance originated in the 1960s. In 1962 the Nasser Social Bank, a micro-finance bank, was established in the Egyptian delta town of Mit Ghamr, to operate exclusively under Islamic principles. This was followed by the establishment of the Islamic Development Bank in 1975, a multilateral development bank headquartered in Saudi Arabia, and a year later, the first Islamic commercial bank, Dubai Islamic Bank, started operations in the UAE.

Formerly deemed a marginal industry by some, Islamic finance is now recognised as a vital and thriving market. It has been widely acclaimed as the fastest growing sector within the financial arena. Industry reports indicate the size of global Islamic assets are estimated to range from $500bn to $1,000bn – with impressive annual growth rates of 15-20%. There are currently over 300 financial institutions operating on the basis of non-interest based instruments in more than 70 different countries. The key markets for Islamic finance are the Middle East, Malaysia, Pakistan and the UK.

How is Islamic finance different?

The key differences between Islamic finance and conventional finance are that in Islamic finance:

- A Muslim is not permitted to collect or pay interest or 'riba' on a loan. Central to Islamic finance is the fact that money itself has no intrinsic value; it is simply a medium of exchange. To comply with these rules, interest is not paid on Islamic savings or current accounts, nor is it applied to Islamic mortgages.
- Risk and profit must be shared between parties to a transaction. The rationale is to link the return in an Islamic contract to productivity and the quality of the project, thereby ensuring a more equitable distribution of wealth. The Shari'ah position is simply that if you lend someone money, then you do not receive any interest. But if you are prepared to go into a business with the person, then you share in the risks.
- Contracts have to be transparent and stipulate exact terms, with all parties having full knowledge of what is involved, thereby avoiding a sale that may represent a gamble (for example, conventional short sales or sales on margin are prohibited). Speculation and uncertainty in transactions are not allowed.
- In Islamic banking, the bank has to back up all transactions with a tangible asset.
- Investment in some activities, for example, gambling, pornography, and the consumption of alcohol, are considered 'haraam', or unlawful under Shari'ah.

If banks can not charge interest, how do they make money?

Banks make their money through the buying and selling of approved goods and services, with the principal means of Islamic finance based on trading (as long as risks and profits are shared between

banks and investors in compliance with Shari'ah). Indeed, the earning and sharing of profit is very much encouraged within Islam.

Although they cannot charge interest, banks are able to profit from helping customers to purchase assets using schemes such as 'ijara' or 'murabaha'. Ijara is a leasing agreement whereby the bank buys an item for a customer and then leases it back over a specific period. Murabaha is a form of credit which enables customers to make a purchase without having to take out an interest bearing loan. The bank buys the required asset and then sells it on to the customer on a deferred basis. A price is agreed at the outset which will include an element of mark-up. This profit is viewed as being a reward for the risk that the bank assumes. This has been particularly successful as an alternative form of debt financing.

In some ways, it is misleading to describe an Islamic bank as a bank, as it is actually an active participant as a trader, manufacturer, and intermediary depending on the transaction.

The future of Islamic finance

The global market has seen significant changes over the past five to ten years. Over the last decade, Islamic banking and finance has emerged as a rapidly-growing alternative system of financial management, and global market participants and policy makers are increasingly paying attention to its potential.

Both New York and London have launched indices affiliated to their main Dow Jones and FTSE indices, to provide a benchmark for equity prices for investments in Islamic financial institutions. The UK Government has also tried to make the City of London the global centre of Islamic finance through measures including the abolition of double stamp duty on Islamic mortgages, and the recently announced plans to test the feasibility of issuing Shari'ah compliant 'sukuk' bonds. The 2007 Budget introduced new measures for sukuk bonds to be issued, held and traded on the UK financial market.

Indeed, the emergence and growth of sukuk instruments (commonly referred to as 'Islamic bonds') have revolutionised the Shari'ah-compliant debt securities sector. They have not only given momentum to the Islamic financial industry on a global scale, but have also provided opportunities for the development of secondary debt markets. After the German state of Saxony-Anhalt became the first non-Muslim issuer to enter the Islamic debt market in 2004, US and Japanese firms have also issued sukuk bonds. In the UK, the leveraged buy out of Aston Martin from Ford (2006) was carried out using a sukuk instrument.

After three decades of its contemporary development, Islamic finance is now firmly established and here to stay. Perhaps the six core challenges for the sector are;

- The development of uniform prudential, supervision, and accounting standards;
- Shariah convergence (a uniform set of basic Islamic legal principles relating to financial transactions) and standard documentation;
- The development of an Islamic capital market to provide liquidity and secondary trading;
- Product innovation away from short-term instruments to more medium-and-long term equity and debt structures;
- Creating greater awareness of Islamic banking through creative marketing and education; and
- Meeting the human capital requirements needed to service the growing industry.

Guide to the key terms

For financing working capital and liquidity management

1. *Murabaha*: **cost-plus** financing, as used for trade and asset finance, allowing deferred payment by customers.

2. *Istisna'a*: aimed at long term construction projects, this is one of two types of finance which allows the sale of a commodity prior to it coming into existence.

For asset finance

3. *Ijara*: this is a quasi-debt instrument, essentially equivalent to **leasing**. Often used in the context of home purchasing.

Equity-like instruments

4. *Musharakah*: this is akin to a **joint venture** arrangement, through an equity participation contract. Ownership is distributed according to each partner's share in the financing, and profit and loss is shared by the partners. Often used in connection with large project finance and private equity funds.

5. *Mudarabah*: essentially an **investment fund** where one party provides the entire capital, and the other party provides the management (usually the bank, but can be in reverse). Profit sharing is agreed up-front, although the loss is borne by the provider of the funds alone.

Fixed income investment

6. *Sukuk*: an investment certificate (**bond**) that represents a proportionate interest in a well defined pool of assets that yield income and capital returns. Usually set up through the conventional securitisation process, with a special purpose vehicle acquiring the assets, with the returns from the assets being passed to sukuk holders (investors). To date popular asset classes have included real estate. This method has been a popular way for many governments to raise funds for infrastructure.

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