

An overview of Islamic finance: History, instruments, prospects¹

Panorama de la finanza islámica: Historia, herramientas y futuro

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Abstract: Islamic finance has grown rapidly over the past few decades to become a \$2 trillion industry. It is based on the principles of the Sharī'a (Islamic law), notably the prohibition of *ribâ* (interest) and the avoidance of activities considered *harâm* (unlawful), such as gambling or alcohol consumption. This paper explores the rationale behind the industry; its history; its instruments, products, and services; its appeal to both Muslims and non-Muslims; and the controversy that surrounds it.

Keywords: Islamic finance; Islamic banking; Sharī'a; *ribâ*; *sukûk*.

Resumen: La industria de las finanzas islámicas ha crecido rápidamente en las últimas décadas, alcanzando un valor de 2 billones de dólares. Se basa en los principios de la Sharī'a (ley islámica), que prohíbe la *ribâ* (interés) y ciertas actividades consideradas *harâm* (ilegal), como el juego y el consumo de alcohol. Este documento explora la motivación de la industria; su historia; sus instrumentos, productos y servicios; su atractivo, tanto para musulmanes como para no musulmanes; y la controversia que la rodea.

Palabras clave: Islamic finance; Islamic banking; Sharī'a; *ribâ*; *sukûk*.

¹ *Note on the transliteration:* In this paper the transliteration of Arabic has been simplified, only indicating long vowels (with a caret: *â, î, û*), the glottal letter, *'ayn* (´), and the glottal stop, *hamza* (´). We have omitted the *tâ' marbûta* when it is not pronounced (although it is often transcribed as a final "h," e.g. "Shariah"; here that term appears as Sharī'a, signalling the stress on the *ya*´ and the presence of an *'ayn*). In proper names, the usual transcription has been retained.

Over the last few decades Islamic finance has grown rapidly to become a \$2 trillion industry. It is based on the principles of the Sharī‘a (Islamic law), notably the prohibition of *ribā*, defined as the payment of interest, and the avoidance of economic activities considered *harām* (unlawful), such as gambling, pornography, or the consumption of alcohol and pork.

This paper presents an overview of Islamic finance. We start with a historical survey of the phenomenon, tracing it back to the prohibition of usury in Judaism and to the early days of Islam, then jumping to its appearance in modern times, back in the 1960s. Next we examine the instruments of Sharī‘a-compliant financing and the products and services offered by Islamic Financial Institutions (IFIs). We wrap up by going over the main arguments around the industry, both in favour and against.

1. MONEYLENDING IN THE ABRAHAMIC RELIGIONS²

Islam appeared in the context of a society that was becoming more stratified and unequal as a consequence of sedentarisation and the emergence of a rich merchant class, which weakened traditional Bedouin values such as solidarity and hospitality. As a result, one of the main concerns of the new religion was to cultivate social cohesion through the promotion of social justice, and the Qur’ān constantly exhorts Muslims to be charitable to the most vulnerable: orphans, the needy, the wayfarer.

On the other hand, the holy book of Islam describes its message as the continuation (and culmination) of God’s message to humankind, and Muhammad is characterised as the last in a line of prophets that began with Adam and includes the Biblical patriarchs and Jesus. Islam therefore adopted many of the rules and mandates of Judaism. One of them was the prohibition of charging interest, which the Torah describes as an abomination and had become widespread in pre-Islamic Arabia.

Paradoxically, the Jews were known for the practice of usury, which was possible because of an exemption that allowed them to lend money to non-Jews:

² For more on the history of money-lending, see Mews, Constant J. and Abraham, Ibrahim. 2007. “Usury and Just Compensation: Religious and Financial Ethics in Historical Perspective,” *Journal of Business Ethics* 72/1, pp. 1-15; Marie-Jeanne, Caroline. 2013. “L’interdiction du prêt à intérêt : principes et actualité.” *Revue d’économie financière* 109 (March), pp. 265-282.

Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury: that the Lord thy God may bless thee in all that thou settest thine hand to in the land whither thou goest to possess it.³

This is undoubtedly a double standard, but we should not forget that religions commonly dictate different treatment for outsiders, and it could be argued that Jewish moneylenders were providing a service demanded by society.

In addition, in the Middle Ages in Europe Jews were banned from many economic activities and pushed into badly-regarded occupations such as tax and rent collecting, as well as moneylending. In turn, this contributed to their persecution; usury was the justification for the Edit of Expulsion of the Jews from England in the XIII century. In effect, Christianity also frowned upon moneylending, which the Church considered a sin and was forbidden by canonical law. Nevertheless, it was permitted by civil law and widely practised, not only by Jews but also by Christians, such as the Lombard bankers – often at extortionate rates of interest.

Going back to Islam, the Qur’ân only contains a handful of verses dealing with financial matters, but they are unambiguous in their condemnation of *ribâ* (literally, “elevation”, commonly translated as “usury”⁴), e.g.:

Those who swallow usury [*ribâ*] cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) – Such are rightful owners of the Fire. They will abide therein.

Allah hath blighted usury and made almsgiving fruitful. Allah loveth not the impious and guilty.⁵

In fact, when Muhammad fell out with the Jewish tribes in Medina, which refused to acknowledge him as a prophet, usury is mentioned as one of the reasons behind God’s “condemnation” of the Jews:

³ Deuteronomy 23:20 (King James Version).

⁴ In most translations of the Qur’ân, *ribâ* is translated as “usury,” which is the most common interpretation among Muslim scholars. Others believe that the term refers only to excessive interest, as we will see below.

⁵ Qur’ân 2:275-276. We use Pickthall’s translation throughout.

Because of the wrongdoing of the Jews We forbade them good things which were (before) made lawful unto them, and because of their much hindering from Allah's way.

And of their taking usury when they were forbidden it, and of their devouring people's wealth by false pretences, We have prepared for those of them who disbelieve a painful doom.⁶

However, Islam did not discourage economic entrepreneurship. Quite the opposite, as made clear by the first of the verses quoted above, which contrasts trade to usury. Muhammad himself was a merchant, as were many of his close companions (*Sahāba*).

Indeed, the Golden Age of Islam was an era of economic prosperity made possible by the widespread use of a stable currency, the dinar, and the introduction of financial instruments such as cheques, bills of exchange and promissory notes. These instruments were adopted in Europe in the Late Middle Ages and became an integral part of the modern economy. Even the work “risk” is derived from the Arabic *rizq* (“livelihood”, “God’s blessing”).⁷ It first appears in a 12th-century text to refer to a financial transaction in which a lender entrusted an agent a sum of money to invest, in the understanding that the lender would assume “the risk” in the venture failed.⁸

Despite religious prohibitions, the demand for credit meant that charging interest was common both in the Christian and the Muslim worlds. Moneylenders and merchants resorted to similar subterfuges (in Arabic *hiyal*, plural of *hila*, “ruse”), such as the *mukhâtara*. This consisted of two contracts: in the first, the borrower sold the lender some object for an amount immediately payable in cash; in the second, the borrower agreed to buy that object back for a higher price at some time in the future. That price difference was, in reality, interest. This practice was imitated in the Christian

⁶ Qur’ân 4:160-161.

⁷ There are several examples in the Qur’ân, e.g.: “O ye who believe! Eat of the good things wherewith We have provided you [*razaqnâ-kum*], and render thanks to Allah if it is (indeed) He Whom ye worship.” (2:172); “Say (O Muhammad): Lo! my Lord enlargeth the provision [*al-rizq*] for whom He will and narroweth it (for whom He will). But most of mankind know not.” (34:36); “Know they not that Allah enlargeth providence [*rizqa*] for whom He will, and straiteneth it (for whom He will). Lo! herein verily are portents for people who believe.” (39:52).

⁸ S. Piron quoted in Mews and Abraham, op. cit., p. 4.

world, where the *contractus mohatra* became so common that it was expressly condemned by the Catholic Church in 1679.

By then, the Reformation had allowed charging interest as a necessary evil, reflecting the need for capital of the nascent bourgeoisie. As a matter of fact, interest is one of the pillars of capitalism, which became globalised with the expansion of Europe and the rise of the colonial empires.

2. A BRIEF HISTORY OF ISLAMIC FINANCE⁹

The first Islamic financial institutions of the modern era were created in the 1960s. In Egypt, a small interest-free savings bank was established at Mit Ghamr, in the Nile Delta, in 1963, and over the next three years it opened eight more branches in other localities. In 1967 they were all either closed or merged with government banks, most likely for political reasons.¹⁰ Also in 1963, the Pilgrims' Fund (Tabung Haji) was set up in Malaysia to provide facilities for Muslims wishing to save for the *hajj* (pilgrimage to Mecca). It flourished, and it now provides a wide range of services to its 9 million depositors.¹¹

In 1974 the Organisation of the Islamic Conference (OIC, now Organisation of Islamic Cooperation) launched the Islamic Development Bank as a multilateral lending institution to provide Sharî'a-compliant funding to development projects in member countries. It began its operations in 1977. Around the same time several major Islamic commercial banks were established, the first being Dubai Islamic Bank, in 1975, and Faisal Islamic Bank of Sudan and Kuwait Finance House, both in 1977. Iran transformed its banking system in the 1980s, in the aftermath of the 1979 Islamic Revolution. Around the same time Pakistan tried – and failed – to Islamise its entire banking sector. Sudan followed suit, with more “success” due to its economic and political isolation.

⁹ For a more comprehensive overview of the development of Islamic banking, see Pastré, Olivier and Gecheva, Krassimira. 2008. “La finance islamique à la croisée des chemins,” *Revue d'économie financière* 92, pp. 197-213 (especially pp. 199-205).

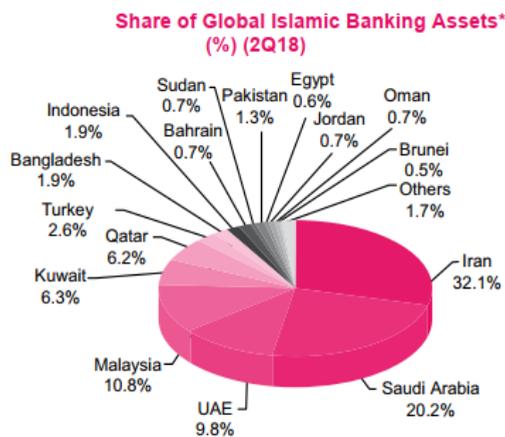
¹⁰ It seems likely that the Nasserist regime, which had dealt harshly with attempts by the Muslim Brotherhood to bring about an Islamist order in Egypt, did not look kindly on an experiment that smacked of Islamism. For a noteworthy attempt at piecing together the history of this early example of Islamic banking, see Orhan, Zeyneb Hafsa. 2018. “Mit Ghamr Savings Bank: A Role Model or an Irreplicable Utopia?,” *The Journal of Humanity and Society* 8/2, pp. 85-102.

¹¹ See “About Us,” *Tabung Haji*, in www.tabunghaji.gov.my/en/corporate/corporate-information/about-us

It is no coincidence that Islamic finance took off in the 1970s. It was aided by a general religious revival that was most dramatically manifested in the emergence of the Islamic Republic of Iran and in the instauration of Islamist regimes in Pakistan under Muhammad Zia ul-Haq and in Sudan under Omar al-Bashir. In addition, the oil shocks in 1973 and 1979 meant a huge increase in the revenues of producers such as the Gulf monarchies, which promoted Islam as a counterweight to Arab socialism.

Since then, the sector has spread to other regions of the world – notably to Southeast Asia, but also to Western countries with large Muslim communities and to sub-Saharan Africa. Moreover, it has diversified from banking into insurance and reinsurance, stocks and bonds, mutual funds... mirroring the massive growth in FDI and portfolio investment since the 1990s. On the other hand, political tensions after 9/11 prompted many Muslim investors to repatriate part of their savings and reconsider their investments.

Islamic finance has become a huge industry, with a total worth in excess of \$2 trillion, more than a thousand IFIs (Islamic Financial Institutions), and a presence in over 80 countries. The largest share of assets is in Iran, where the entire banking sector is Islamic, but members of the Gulf Cooperation Council concentrate almost 45% of the assets.



*The share is apportioned in US Dollar terms.

Source: IFSB¹²

¹² Islamic Financial Services Board. 2019. "Islamic Financial Services Industry Stability Report 2019" (July), in www.ifsb.org/sec03.php, p. 12.

Apart from Iran and Sudan, there are a dozen Muslim countries with a significant share of Islamic banking (see table below). In the rest there are only a handful Islamic banks, and/or conventional banks have opened “Islamic windows,” including Western institutions such as HSBC, Barclays, Citigroup, BNP Paribas, UBS and Deutsche Bank.

Country	Islamic banking market share (percent)*
1. Iran	100
2. Sudan	100
3. Brunei	64
4. Saudi Arabia	63
5. Kuwait	40
6. Yemen	30
7. Malaysia	30
8. Qatar	25.4**
9. Mauritania	21.4***
10. United Arab Emirates	20.4
11. Bangladesh	19.8
12. Djibouti	16.9
13. Jordan	15.5
* 2017 data / ** 2016 data / *** 2015 data	

Source: IMF¹³

The sector is expanding at a strong pace helped by factors such as economic and demographic growth, raising savings, competitive pressures, regulatory advancements, and increasing financial inclusion. Furthermore, it is becoming more and more popular in Western countries with large Muslim populations like the UK, the US, France, and Germany. In fact, Islamic banks report an increasing number of non-Muslim customers attracted by the industry’s ethical avoidance of certain investments as well as by events like the 2008-9 financial crisis and the Libor rate-fixing scandal, which damaged the reputation of conventional finance – but also by very competitive returns.¹⁴

¹³ International Monetary Fund. 2018. “The Core Principles for Islamic Finance Regulations and Assessment Methodology” (April), in www.imf.org/en/Publications/Policy-Papers/Issues/2018/05/24/pp040618the-core-principles-for-islamic-finance-regulations-and-assessment-methodology, p. 19.

¹⁴ A 2015 article in *Newsweek* reported that the Islamic Bank of Britain had seen a 55% increase in applications for savings accounts by non-Muslims after the Libor scandal, and that the British-based Al Rayan bank had reported that 83% of the customers who had made fixed-term deposits over the previous two years had been non-Muslims. A 2018 article in

As the figure below shows, banking continues to be the largest segment in the Islamic financial industry by far. However, the other segments are growing rapidly, particularly the Islamic capital market. The third, much smaller, segment is insurance (*takâful*).



Source: IFSB¹⁵

3. KEY PRINCIPLES OF ISLAMIC FINANCE

The principles of Islamic finance are based on the Sharî‘a (literally “path”, commonly translated as Islamic law), the religious precepts governing the lives of Muslims. The main sources of the Sharî‘a are the Qur’ân, the revealed book of Islam, and the Sunna, the collections of *ahâdîth* (plural of *hadîth*, “tale”, “report”) that relate the words and deeds of prophet Muhammad.

In addition to these, Islamic jurisprudence (*fiqh*) also relies on secondary sources: *qiyâs* (analogical reasoning), *ijmâ‘* (scholarly consensus), and *ijtihad* (independent reasoning). The different branches of Islam comprise several schools of jurisprudence (*madhâhib*, plural of *madhhab*), which explains different interpretations of the sources. Nevertheless, there is also a high degree of agreement among scholars, and the legal schools of Sunni Islam have historically acknowledged each other’s validity.¹⁶

The Economist revealed that one in three of Al Rayan’s customers are non-Muslims, as are the “vast majority” of the customers of the Bank of London and the Middle East. See Capon, Felicity. 2015. “First Islamic Bank To Open In Germany,” *Newsweek* (23 March), in www.newsweek.com/first-islamic-bank-open-germany-316134; The Economist. 2018. “Why non-Muslims are converting to sharia finance” (20 October), in www.economist.com/britain/2018/10/20/why-non-muslims-are-converting-to-sharia-finance

¹⁵ “Islamic Financial Services Industry Stability Report 2019,” op. cit., p. 7.

¹⁶ The branches of Islam are Sunnism, which over 80% of Muslims adhere to; Shiism, followed by most of the rest; and the much smaller Ibadi movement, dominant in Oman and

Fiqh is divided into two domains: *'ibādāt* (rituals) and *mu'āmalāt* (social relations). The latter provides the rulings that govern Islamic finance. Since the 1970s, IFIs have set up Sharī'a boards made up of jurists (*fuqahā'*, plural of *faqīh*) specialised in *fiqh al-mu'āmalāt*, who issue *fatāwā* (plural of *fatwā*, ruling) on whether the financial products on offer are Sharī'a-compliant.

As mentioned above, the main principle of Islamic finance is the prohibition of *ribā*. Islamic jurisprudence defines it as “surplus value without counterpart,” which is usually understood as any form of interest. The prohibition is aimed at protecting the poor and vulnerable and preventing injustice. Some *fuqahā'* have argued that *ribā* only refers to excessive interest, and a now (in)famous *fatwā* issued by the prestigious Al-Azhar University in 2002 ruled it *halāl* (permissible) to receive interest on banks deposits,¹⁷ but that remains the minority position.

Following from the prohibition of *ribā*, returns on investment can only be earned through two means: participation in productive activities, assuming both risks and returns; and the lease or sale of goods, which may require some kind of credit. In either case, economic activities should produce value in the form of products and services and be based on actual assets. This ensures a link between finance and the real economy, which has wider implications for what is considered *halāl*. For instance, the Sharī'a makes the sale of an asset conditional on ownership of the asset in question, thereby forbidding practices such as short selling.

Linked to the rationale of preventing injustice and protecting the vulnerable is the prohibition of *gharar* (risk, hazard), typically translated as “excessive uncertainty” or “ambiguity.” This refers to the need for contracts to include comprehensive details in terms of price, quantity, quality, delivery date, etc., but also to the moral duty on the parties to disclose all information that might be relevant to the transaction.

Finally, certain activities are deemed *harām* (forbidden) or *makrūh* (undesirable) in Islam, therefore the Sharī'a prohibits investment in industries that promote them: gambling (*maysir* or *qumār*), alcohol and

present in certain regions of the Maghreb and East Africa. The schools of jurisprudence of Sunni Islam are the Hanafī, the Mālikī, the Shāfi'ī and the Hanbalī, all named after their founders.

¹⁷ The text of the *fatwā* is quoted in full in Mohammed, Naveed. 2014. “Al Azhar University fatwa allows for fixed returns on bank deposits,” *Sukuk.com* (20 March), in www.sukuk.com/education/al-azhar-university-fatwa-interest-bank-deposits-271

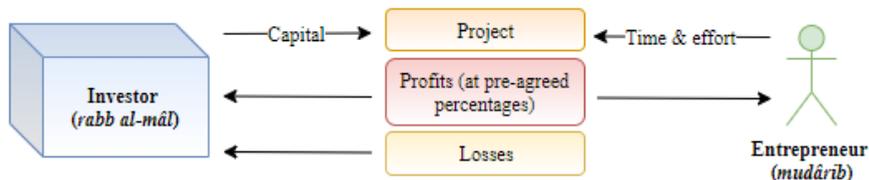
drugs (including tobacco), the consumption of pork, the manufacture and sale of armaments, pornography, and, often, the entertainment industry.

4. MAIN INSTRUMENTS OF ISLAMIC FINANCE

The Sharī‘a offers two types of mechanisms to finance investments: participative arrangements, sharing the potential risk of a project; and credit integrated in a transaction of goods. The first type of mechanism is the closest to the spirit of Islamic financing. Scholars have expressed some reservations about the second, which remains, however, much more common.

Participative arrangements, known as profit- and loss-sharing (PLS), involve lenders in the project they finance and dictate that the profit be variable, depending on the success of the project, instead of fixed or guaranteed as in conventional finance. There are two main types of PLS: *mudâraba* and *mushâraka*.

- *Mudâraba* (translated as “limited partnership”) is a passive partnership in which an investor (*rabb al-mâl*, literally “the owner of the capital”) provides the money and an entrepreneur (*mudârib*), his/her time and effort. Any profits are shared between the parties according to proportions pre-agreed in the contract, but losses are assumed by the investor. This is the most frequent model of PLS.

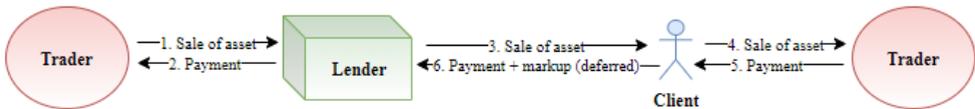


- *Mushâraka* (“joint enterprise”) is an active partnership in which the parties (*shurakâ*, plural of *sharik*, “partner”) contribute assets to an enterprise and share profits and losses according to a percentage set in the contract, normally coinciding with the proportion of assets they have contributed.

The second type of mechanism provides credit to finance consumer or corporate debt, asset rental, and manufacturing. Islamic finance proposes several options; the more common are *murâbaha* and *ijâra*, but *salam* and *istisna*’ are also used.

- *Murâbaha* (known as “cost-plus financing”) is by far the most used instrument in Islamic financing. In it a lender, usually a bank, buys an asset on behalf of a client (real estate, machinery, a vehicle...) and sells it to the client through periodic payments spread over time, adding a markup to its original price.

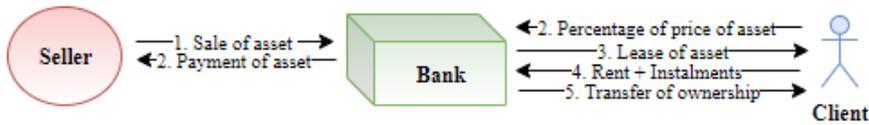
There is a type of *murâbaha* known as *tawarruq* (from *waraq*, “paper money”, also known as “Islamic monetisation”) which entails the lender acquiring a commodity from a trader and selling it to the client with a markup. The client immediately sells the commodity on to obtain liquidity, but payment to the lender is deferred.



Tawarruq is widely used to finance international trade and in interbank lending for liquidity management. Nonetheless, many *fuqahâ* consider it a *hila* (“ruse”, see above), and thus invalid, especially if the client sells the commodity back to the original trader.

- *Ijâra* (“lease”) is a kind of leasing in which the bank acquires a property or a product on instructions from a client and makes it available to the latter for a fixed period in return for a regular payment. Unlike in *murâbaha*, the bank retains ownership of the asset, is responsible for its maintenance, and bears all risks associated with it. It may be accompanied by a purchase option at maturity or during the term of the contract, with the price of the residual asset agreed in advance. In this case, it is known as *ijâra wa-iqtinâ* (“lease and purchase”) or *ijâra muntahiya bi-l-tamlîk* (“lease ending in ownership”).

An innovation in Islamic finance is *mushâraka mutanâqisa* (diminishing *mushâraka*), which combines *ijâra* and *mushâraka*. It is frequently used in house financing and consists of a partnership between the bank and the client in which both parties provide capital to acquire a property at an agreed percentage (the client contributing at least 25% of the price). The client then rents the property and makes a regular payment that includes the rental, which is split between the parties on the basis of the current equity share, and a sum destined to buy back the bank’s share of the property in instalments, until the full equity is transferred. This type of contract is common in Iran.



In practice, the markup on the value of the asset is usually aligned with the interest charged in conventional loans. In spite of this, *murâbaha* and *ijâra* are deemed legitimate from an Islamic point of view because the markup is not linked to an interest rate but is a fee fixed in advance, thus eliminating the element of uncertainty. In addition, it can be argued that what is being charged is not interest but the appreciation in the value of the asset.

- *Salam* or *bay' salam* (“forward buying,” or “advance payment sale”) entails payment in advance and in full for goods which will be delivered at a future date, e.g. agricultural produce. The contract grants the seller the liquidity to finance production, while the buyer is guaranteed receipt of the goods without any price fluctuation and can then sell them on at a higher price. This type of contract is traditionally aimed at small farmers, and the bank may ask for a mortgage or some other guarantee to reduce its exposure to credit risk.
- *Istisnâ'* (manufacture) is similar to *salam* in that an investor agrees to pay for certain goods in advance for a fixed price. However, payment is deferred or made in instalments linked to project completion. This type of contract is commonly used to finance infrastructures such as roads, factories, hospitals... Risk mitigation is contemplated through *takâful* (insurance), a quality assurance agreement, or a modification of the final price in case of unforeseen circumstances.

Less common than other Islamic financing instruments, *salam* and *istisnâ'* are exceptions to the rule that the seller should be in physical possession of the asset being sold (which does not yet exist). In both cases the bank normally acts as a facilitating agent or intermediary on behalf of a third party.

As well as those financing instruments, Islamic banks offer their customers a number of services similar to those of conventional banks, e.g.:

- *Wadi'a* (deposit) current account: The bank holds funds for an individual and guarantees that they will be available on demand; in exchange, it is given permission to use those funds in its operations. The deposit does not earn a return, but the bank may encourage depositors to keep a minimum balance by

granting them a share of its profits or some other form of reward (*hiba*), from time to time and at its sole discretion.

- *Qard hasan* (literally “good loan”)¹⁸: It is the only loan mentioned in the Qur’ân,¹⁹ where it refers to a transaction between a Muslim and God in which the first sacrifices worldly resources in the path of God to be rewarded in the hereafter. In the context of modern Islamic finance, the term designates an interest-free loan offered by a bank, usually to a loyal customer in difficulties or wishing to embark on a small or medium-sized project. It is often lent from *zakât* funds.²⁰
- *Mudâraba* savings account: The client enters into a partnership with the bank and shares in its profits and losses, as in the *mudâraba* financing mechanism. Banks typically hold a “profit equalization reserve” (PER) in order to smooth the returns to savers and even continue to pay dividends when their investment activities are less than successful, but this is controversial among Sharî‘a scholars because it makes the product look too much like a conventional, interest-paying savings account.²¹
- *Murâbaha* commodity deposit: It works similarly to the *tawarruq* mechanism described above: the customer buys a commodity (in practice, the purchase is arranged by the bank) and sells it to the bank, which sells the commodity on

¹⁸ Confusingly, the term *qard hasan* is sometimes used to refer to deposits, which are then considered interest-free loans from the customer to the bank. See Visser, Hans. 2013. *Islamic Finance: Principles and Practice* (2nd ed.). Cheltenham, UK & Northampton, Massachusetts: Edward Elgar, p. 107.

¹⁹ It is mentioned six times, e.g. “Who is it that will lend unto Allah a goodly loan (*qardan hasanan*), so that He may give it increase manifold? Allah straiteneth and enlargeth. Unto Him ye will return.” (2:245); Lo! those who give alms, both men and women, and lend unto Allah a goodly loan (*qardan hasanan*), it will be doubled for them, and theirs will be a rich reward. (57:18).

²⁰ *Zakât* is one of the five pillars of Islam, and a religious obligation for all Muslims who can afford it. It consists of an annual mandatory charitable donation, customarily amounting to 1/40 (2.5%) of accumulated wealth.

²¹ For more on this product, see Sapuan, Noraina Mazuin. 2016. “An Evolution of Mudarabah Contract: A Viewpoint from Classical and Contemporary Islamic Scholars,” *Procedia Economics and Finance* 35, pp. 349-358. The author glosses over the controversy surrounding PERs by referring to the “flexible approach” adopted by Sharî‘a Boards in the Malaysian Islamic finance sector (p. 355). Instead, she focuses on the risks arising from this type of contract when it is used as a tool to finance entrepreneurs (i.e. agency problems, such as adverse selection and moral hazard) and how to overcome them.

straight away to obtain liquidity and pays back to the customer with a markup when the investment period is up.

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Minimum Deposit amount of SAR 50,000.

Multiple Currencies
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Investment period

1
months
MINIMUM

12
months
MAXIMUM

Exceptional Investment period
The investment period is minimum 3 months only if the investment amount varies between:

50,000
SAR
MINIMUM

100,000
SAR
MAXIMUM

Example of a *murâbaha* deposit.²²

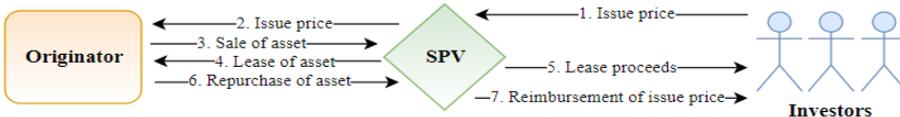
- Credit cards: Islamic banks offer what is basically a standard debit card. After using it, the client receives a monthly invoice which is debited to his or her account – technically, interest-free credit since the purchase until then. A credit limit is assigned depending on the client’s credit-worthiness. So-called revolving credit cards, which include a line of credit and charge interest (frequently 20% a year), are not considered compatible with the Sharī‘a.

In addition, a number of Islamic financial products have been developed to meet customer needs with Sharī‘a-compliant alternatives to conventional products, e.g. insurance, bonds, and investment funds:

- *Sukūk* (plural of *sakk*, deed): They are known as Islamic bonds, but unlike conventional bonds, which are based on the repayment of a loan with interest, *sukūk* represent partial ownership of a revenue-generating asset or service, and *sukūk* holders receive income either from the profits generated by that asset or service or from rental payments made by the issuer.

Sukūk can be designed according to different structures, the most common being *ijāra*: The company that requires the funding, or originator, sets up a special-purpose vehicle (SPV) which issues the *sukūk* and uses the proceeds from their sale to buy the asset from the originator. The SPV then leases the asset back to the originator and distributes the rent payments among the *sukūk* holders. At maturity, the asset is sold back to the originator and the issue price is reimbursed.

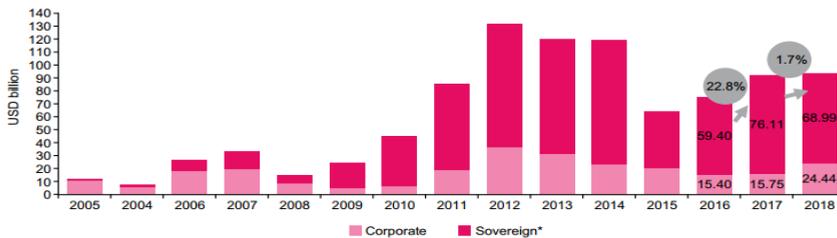
²² Saudi Investment Bank. Undated. “Murabaha Deposit,” in www.saib.com.sa/en/MurabahaDeposit



The OIC defined (and legitimised) *sukūk* in 1988, paving the way for the development of the *sukūk* market. The first *sukūk* were issued in Malaysia in 1990, but the first international issue – also by a Malaysian company – did not take place until 2001. That same year, Bahrain launched the first sovereign *sukūk*. Others soon followed, often to fund infrastructure projects. The dynamism of the market has attracted non-Muslim investors and even issuers: In 2004 the German state of Saxony-Anhalt became the first non-Muslim sovereign borrower to enter the *sukūk* market, and in 2014 the UK and Luxembourg became the first non-Muslim countries to issue sovereign *sukūk*.²³

The figure below shows the evolution of *sukūk* issuances, both corporate and sovereign, and clearly illustrates the effect of oil price fluctuations on the sector.²⁴

Chart 1.3.1.1 *Şukūk* Issuance Trend (2005–18)



*Includes all government-related entities (GREs), multilateral development banks (MDBs) and international organisations (IOs). For the purposes of this report, “GRES” refers to *şukūk* obligors with a shareholding structure representing more than two-thirds (66.67%) of government ownership through either ministries, authorities, etc. or other GREs such as sovereign wealth funds.

Source: IFSB Secretariat Workings

Source: IFSB.²⁵

²³ For an overview of the history of *sukūk*, their different structures, and several case studies illustrating their use, see Jabeen, Zohra, and Javed, Mohammad Tariq. 2007. “Sukuk-Structures: An Analysis of Risk-Reward Sharing and Wealth Circulation.” *The Pakistan Development Review* 46/4, pp. 405-419; Wedderburn-Day, A. Roger. 2010. “Sovereign ‘sukuk’ Adaptation and innovation,” *Law and Contemporary Problems* 73/4, pp. 325-333; and Latham & Watkins. 2017. “The Sukuk Handbook: A Guide To Structuring Sukuk,” in www.lw.com/thoughtLeadership/guide-to-structurings-sukuk

²⁴ The drop in 2008 can be explained by the financial crisis and consequent fall in oil prices, but also by a controversial statement by the chairman of the Sharia Standards Committee of the AAOIFI which caused uncertainty in the *sukūk* market (see below).

²⁵ “Islamic Financial Services Industry Stability Report 2019” (op. cit.), p. 19.

- Islamic investment funds: Initially focused on real estate projects, the sector has now diversified and is growing rapidly. The funds are usually managed according to either the *mudârabâ* or the *wakâla* model. The first is similar to the partnership structures described above: one party provides the funds and the other is responsible for the administration of the enterprise, and each of them receives a share of the profits according to a pre-agreed ratio. In the *wakâla* (agency) model, a *wakîl* (agent) manages the funds on behalf of the *muwakkil* (mandator), making Sharî‘a-compliant investments. The *muwakkil* receives a pre-agreed return, while the *wakîl* receives a fee and, as an incentive, any profits exceeding that pre-agreed return.

Muslim investors were reassured and encouraged by the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), funded in 1991 in Bahrain to issue accounting, auditing and Sharî‘a standards for the industry. The dynamism of the sector subsequently prompted Western financial services companies to create mechanisms to screen Sharî‘a-compliant stock: FTSE Global Islamic Index Series (GIIS) and Dow Jones Islamic Market Index (DJIMI), in 1999; Standard & Poor’s S&P 500 Shariah Indices, in 2006; and Morgan Stanley Capital International’s MSCI World Islamic Index, in 2007.

INDEX METHODOLOGY

The methodology for the MSCI Global Islamic Indexes follow Sharia investment principles and does not allow investment in companies that are directly active in, or derive more than 5% of their revenues from such business activities as alcohol, tobacco, pork-related products, conventional financial services, defense/weapons, gambling, or adult entertainment.

In addition, the MSCI Global Islamic Indexes do not allow investment in companies deriving significant income from interest or companies that have excessive leverage. MSCI uses three financial ratios to screen for such companies: 1) total debt over total assets; 2) the sum of a company’s cash and interest-bearing securities over total assets; and 3) the sum of a company’s accounts receivables and cash over total assets. None of these financial ratios may exceed 33.33%.

Finally, if a company derives part of its total income from interest income and/or from prohibited activities, Sharia investment principles state that this proportion must be deducted from the dividends paid out to shareholders and given to charity. MSCI therefore applies a *dividend adjustment factor* to all reinvested dividends.

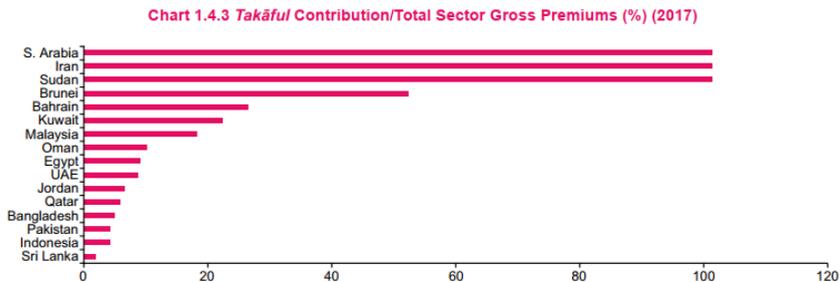
Example of the methodology used to screen Sharî‘a-compliant stocks.²⁶

- *Takâful* (insurance, literally “mutual responsibility”, “solidarity”; from *kafâla*, “guarantee”): Traditional insurance is often considered *harâm* because it involves interest (*ribâ*), incertitude (*gharar*), and hazard (*qumâr*). The Islamic alternative is the *takâful* model: Participants pay a subscription to a fund and make claims from it in case of need, thus protecting each other against losses arising from specified risks. They are the owners the fund, which is managed by a *wakîl* (an individual or a company, such as a bank) charged with investing

²⁶ MSCI. 2019. “MSCI World Islamic Index (USD)” (30 August), in www.msci.com/documents/10199/c0b90e16-5746-4cdc-b033-1ec7da64386e

it in Sharīʿa-compliant projects. Participants are entitled to a share of the fund’s profits after claims are settled.

In Sudan, Iran and Saudi Arabia the insurance market is exclusively Islamic, and *takāful* is also well developed in other countries, such as Brunei, Bahrain, Kuwait, and Malaysia. Globally, the industry is still in its infancy.



Source: IFSB.²⁷

5. A MORE ETHICAL, SOUNDER FINANCIAL SYSTEM?

Beyond the obvious religious motivations, supporters of Islamic finance advance both ethical and economic arguments in favour of the industry. From an ethical point of view, the Sharīʿa forbids investments in a number of economic sectors that many Muslims and non-Muslims alike regard as problematic (e.g. gambling, arms manufacture and sale, the sex industry). In addition, predatory lending practices by Western financial institutions and spiralling debt in Western countries have brought to the fore the issue of excessive interest. Moreover, there is a mounting feeling that the financial sector should have a purpose beyond unfettered returns.

This has led to the advent of the ethical investment sector, which takes into consideration environmental, social, and corporate governance factors (ESG), as shown by the emergence of services like FTSE Russell and MSCI ACWI ESG Universal Index. There is also a growing number of faith-based investment agencies, such as Ave Maria Mutual Funds, Mennonite Praxis Mutual Funds, Lutheran Brotherhood Funds, Jewish Community Investment Fund or STOXX Europe Christian Index. The Islamic financial sector can be seen as part of the same phenomenon.

Incidentally, in 2009 Pope Benedict XVI praised Islamic banking for its ethical dimension, but also as a means to restore confidence after the

²⁷ “Islamic Financial Services Industry Stability Report 2019” (op. cit.), p. 30.

financial crisis,²⁸ which links to the second set of arguments in favour of Islamic finance: financial soundness. Its prohibition of *ribâ* and *gharar* and its emphasis on risk sharing, as well as its strong link to the “real” economy, would help prevent debt spirals and excessive risk taking of the kind that brought the financial system to its knees. The Pope was not alone; in the aftermath of the crisis a number of economists mulled over the lessons that could be learnt from the Islamic financial model.²⁹

However, the sector gives rise to its own risks. A 2017 IMF report identified the following: credit risks when using debt-type contracts for financing, due to the possibility of payment delay or default; market risks, as a result of the volatility of market prices and the absence of hedging instruments; operational risks, e.g. Sharî‘a non-compliance; increasing liquidity risks, caused by the dearth of tradable assets and increasing resort to commodity *murâbaha* markets; rate of return risks, due to mismatches between assets and balances; and displaced commercial risks owing to competitive pressures.³⁰ These concerns have led the IMF to endorse the Core Principles for Islamic Finance Regulation put forward by the Islamic Financial Services Board (IFSB), an organisation set up in Malaysia in 2002 to issue global prudential standards for the industry.³¹

Then there is the issue of the heterogeneity of banking practices in the Islamic financial sector, which reflects the varied interpretations of the sources of the Sharî‘a by the different branches of Islam, its various schools of jurisprudence, and individual scholars. For instance, Southeast Asian countries tend to adopt a more liberal approach to products and services than

²⁸ Puca, Trenz. 2009. “Vatican backs Islamic finance,” *L’Osservatore Romano* (1 April), reproduced (in English) in BCGCM Monthly (June 2009), p. 1, in www.bcgcm.com/pdfs/newsletterjune.pdf

²⁹ They included both Muslim and non-Muslim economists, e.g. Ahmed, Adel. 2010. “Global financial crisis: an Islamic finance perspective,” *International Journal of Islamic and Middle Eastern Finance and Management* 3/4, pp. 306-320; Ribera, Alberto, Etzold, Veit, and Wackerbeck, Philipp. 2011. “Islamic Banking Lessons for the Financial Sector: Soul-Searching After the Crisis,” *IESE Insight* 10, pp 52-59.

³⁰ Shabsigh, Ghiath et al.. 2017. “Ensuring Financial Stability In Countries With Islamic Banking,” *International Monetary Fund* (5 January), in www.imf.org/en/Publications/Policy-Papers/Issues/2017/02/21/PP-Ensuring-Financial-Stability-in-Countries-with-Islamic-Banking, pp. 39-4.

³¹ International Monetary Fund. 2018. “IMF Executive Board Adopts Decisions to Formally Recognize the Core Principles for Islamic Finance Regulation (CPIFR) for Banking” (24 May), in www.imf.org/en/News/Articles/2018/05/24/pr18193imf-adopts-decisions-to-the-cpifr-for-banking. The CPIFR are available to download from the website of the IFSB (www.ifsb.org).

those in South Asia and the Gulf region.³² Some degree of standardisation is needed, and the aforesaid AAOIFI and IFSB have been playing a role in the process. Furthermore, the International Islamic Financial Market (IIFM) was established in Bahrain in 2002 to develop guidelines for Islamic financial instruments. Numerous IFIs are members of both the IFSB and the IIFM, including central banks and the Islamic Development Bank. Nevertheless, the plurality within Islam limits the effectiveness of these initiatives and, in any case, to date they remain consultative.

On the other hand, a significant number of Muslim scholars and academics question the whole enterprise. We have already mentioned the 2002 fatwa by Al-Azhar stating that the payment of interest is not incompatible with Islam. Similarly, economists like Mahmoud El-Gamal of Rice University and Mohammad Omar Farooq of the University of Bahrain have argued that the definition of *ribâ* as any form of interest is not supported by the Qur'ân nor the Sunna, and that Islamic finance products are substitutes to those offered by conventional finance in label, not substance.³³ El-Gamal has coined the term “Sharia arbitrage” to describe the practice by which a conventional financial product is turned into an Islamic product by giving it an Arabic name and making superficial modifications so that it complies with the formalistic aspects of the Sharia, violating its spirit and resulting in increased transaction costs and reduced efficiency.³⁴

Even industry insiders have expressed alarm at the widespread use of *hiyal* as a way to circumvent Islamic prohibitions. In 2007 sheikh Muhammad Taqi Usmani, chairman of the Sharia Standards Committee of the AAOIFI, caused a commotion when he declared that 85% of *sukûk* were un-Islamic. The organisation tried to reassure investors by issuing a statement identifying certain practices as not permissible, but concerns remain.³⁵ Others have tried to propose solutions to the widespread problem

³² This is partly explained by their traditional adherence to the Shâfi'î school of jurisprudence; South Asia and the Middle East countries tend to follow the (stricter) Hanafi and Hanbali schools. As a consequence, Malaysia is considered the world leader in Islamic finance.

³³ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press, Cambridge, New York: 2006); Mohammad Omar Farooq, “‘Qarḍ Ḥasan’, ‘Wadī'ah/Amānah’ and Bank Deposits: Applications and Misapplications of Some Concepts in Islamic Banking.” *Arab Law Quarterly* 25/2 (2011), pp. 115-146.

³⁴ El-Gamal, *op. cit.*

³⁵ Last January the AAOIFI felt the need to issue new, more stringent standards. See Das Augustine, Babu. 2019. “New governance standards to enhance credibility of sukuk issues,”

of “*fatwà shopping*,” whereby IFIs pay Sharī‘a scholars huge sums of money for their rulings, and if a scholar fails to issue a *fatwà* favourable to a new product, they just go to a different one.³⁶

Regardless of those arguments, which are probably best left to Muslims, Islamic finance is one of the fastest-growing segments of the financial services industry and presents enormous opportunities that a growing number of Western institutional investors are taking advantage of.

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³⁶ Kayali, Rakaan. 2018. “Fatwa Shopping, Sharia Boards and Conflicts of Interest,” *Practical Islamic Finance* (1 February), in <https://practicalislamicfinance.com/2018/02/01/fatwa-shopping-sharia-boards-and-conflicts-of-interest>

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