Talking Points

An Introduction to Islamic Finance

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Introduction

Islamic finance is an emergent series of financial products that have been developed to meet the requirements and constraints of people that would like to follow the Shari'ah law. Islamic finance reflects financial business that is not contradictory to the principles of Shari'ah. Conventional finance relies on taking deposits from the public and providing loans to the public.

Elements such as interest and risk, which are commonly found in conventional finance, are prohibited under Shari'ah law. Islamic finance allows those who would like to follow Shari'ah law to invest, save and raise finance by using a method which does not compromise their religious beliefs e.g. investments in forbidden products such as pork, prostitution and alcohol are prohibited under Shari'ah law.

Shari'ah compliance

The central focus of Islamic finance is Shari'ah compliance. A distinctive feature of Islamic finance is the establishment of a Shari'ah Advisory or Supervisory Board to advise the Islamic Financial Institutions (IFIs), Islamic insurance companies, Islamic funds and any other providers which offer Islamic financial products. The establishment of such a board, the opinions of which are binding on each IFI, is required to guide the institutions towards Shari'ah compliance. An institution cannot claim to be doing Islamic financial business until and unless it sets up a Shari'ah Board or Committee consisting of qualified scholars who are of high reputation and who possess the necessary skills.

The Shari'ah Supervisory Board issue a report that is attached with the annual audited financial statements confirming that:

(i) all contracts and transactions which had been entered into during the financial year as presented to the Board had complied with the Shari'ah rules and principles

(ii) the profit distribution and loss bearing on the investment accounts are in compliance with the terms of approval in accordance with the rules and principles of Shari'ah

(iii) all income that has been received from non-Shari'ah compliance sources or by means prohibited by Shari'ah have been cleansed and donated to charitable purposes

(iv) the Zakat calculation has been carried out in accordance with the relevant provisions of Zakat principles

(v) the Shari'ah audit lists all activities and operations (if any) that have been observed not to be in compliance with the Shari'ah rules.

Unlawful goods or services

Another equally important feature is that Islamic finance must not be involved in any activities pertaining to unlawful goods and services. These prohibited goods and services include, among others, non-halal foods such as pork, non-slaughtered animals or animals which were not slaughtered according to Islamic principles, intoxicating drinks, entertainment and pornography, tobacco-related products, and weapons. Non-involvement is not only limited to buying or selling but also includes all chains of production and distribution such as the packaging, transportation, warehousing and marketing of these prohibited goods and services.

Avoidance of Riba

A key to understanding Islamic finance is knowing the meaning of two terms or concepts that must be avoided by Islamic finance in all circumstances; 'Riba' and 'Gharar'. The avoidance of these two elements is a basic requirement of all Islamic financial activities.

Riba

Riba is simply translated into English as 'usury' or 'interest'. Any premium charged on money borrowed is tantamount to Riba irrespective of the amount paid. Riba in its simplest term is an advantage to one party at the expense of another for no appropriate consideration. Islamic commercial law addresses the issue of this unjustified advantage from two possible transactions, namely: in a loan or currency exchange contract and in a barter trading contract.

Muslim jurists have unanimously agreed that two separate classes of asset are susceptible to Riba. These are currency or money and a few commodities, mainly food items. The requirements of an exchange involving these two types of asset are the same.

These requirements are only applicable when there is an exchange of one currency for another currency, whether it is the same currency or different currencies. The requirements also apply to the exchange of a food item for another food item, be it the same food item or of different types.

Gharar - The avoidance of uncertainty or gambling

All transactions made by Islamic Financial Institutions (IFIs) must be free from elements of uncertainty (Gharar) and gambling (Maisir). This is because Gharar may lead to disputes caused by an unjustified term in the contract arising from misrepresentation and fraud. Gambling is seen as an action that always enriches one party at the expense of the other; a zero-sum-game.

The components of Islamic finance

Takaful – Islamic insurance

Takaful is an Islamic alternative to conventional commercial insurance based on the concept of mutual support. Takaful provides mutual protection of assets and property. It is similar to mutual insurance in that members are the insurers as well as the insured.

Sukuk - Islamic bond

Sukuk in Islamic finance is the financial certificate equivalent to conventional debt issuances such as bonds. However, unlike debt issuances, Sukuk holders are the legal and/or beneficial owners of the underlying assets, and as such receive the equivalent of a coupon from the performance of the yielding asset.

Forms of finance

The two most popular forms of finance are Mudarabah and Murabahah.

Mudarabah - Partnership contract:
Under a Mudarabah financing contract the bank agrees to finance the entrepreneur on the understanding that both parties will share the profits of the particular venture being financed.

Murabahah - Cost plus sale:
Murabahah is a sale in which the seller sells his merchandise for more than the price at which he acquired it.

Murabahah is a financing scheme in which a financial institution agrees to purchase merchandise for a client provided that the client promises to purchase it from the financial institution at an agreed mark-up.

Accounting Policies

Although there is an Islamic Board for Auditing and Accounting that issues auditing and accounting policies, they are mostly in line with International Auditing Standards and International Financial Accounting Standards. The reason for this is that both the banking regulators and stock exchanges require that the financial statements of all listed companies prepare on the basis of IFRS.

Depositors' Accounts

The depositors' accounts of an Islamic bank comprise the following:

1. Non-investment accounts - these deposits are not entitled to any profits nor do they bear any risk of loss as the bank guarantees to pay the related balances on demand. Accordingly, these deposits are considered as Qard Hasan from depositors to the bank under Islamic Shari'ah. Investment savings accounts are valid for an unlimited period.

2. Investment accounts - these comprise various types of deposits for unlimited periods and Tawfeer (savings). Unlimited investment deposits are initially valid for one year and are automatically renewable for the same period unless notified to the contrary in writing by the depositor.

In all cases, the investment deposits receive a proportion of the profit (or bears a share of loss) as the Board of Directors of the bank determines based on the results of the financial year. There is a formula that is used for the various types of deposits for unlimited investments.

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