# Islamic finance term paper

However, these entities are governed both by Islamic laws and by the finance industry rules and regulations that apply to their conventional counterparts.

Contrary to popular belief, Islamic finance or banking is not Just for Muslims. It aims to lay the foundations of an ethical and fair financial system, which consequently affects the socio-economic conditions of the market it is implemented in. Islamic financing, hence, can aptly service everyone irrespective of religious beliefs, wealth, ethnicity, caste or creed.

The most distinguishing feature of the Islamic economic system is the prohibition of interest. Usury, Interest and Rib are synonymous terms but they have different technical meanings. Usury refers to the consumption loans given on higher rates and thus causing exploitation of the borrower.

Interest refers to the cost of using money in finance and economic theory. Islamic Banking and Finance in modern times has grown out of the Muslims' desire to find out the ways and means of fulfilling their financial requirements in view of prohibition of interest.

Islamic financing is asset-backed and believes that only assets with an intrinsic value may be sold for a profit, instead of exchanging money, which is considered to have no intrinsic value, for interest. Each unit of money has the same value as the other of the name denomination, which is simply why there cannot be a profit on its exchange. Hence, Islamic finance lays its foundation on real, non-liquid assets; the exchange and sales of which result in fair' profits. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called rib.

Generally, Islamic law also prohibits trading in financial risk (which is seen as a form of gambling). The modern Islamic finance industry is young; its timeline began only a few decades ago. But Islamic finance is evolving rapidly and continues to expand to serve a growing 1. BACKGROUND AND EVOLUTION OF ISLAMIC FINANCE The core concepts of Islamic finance date back to the birth of Islam in the 6th century.

Muslims practiced a version of Islamic finance for many centuries before the Islamic empire declined and European nations colonized Muslim nations.

The modern Islamic finance industry emerged only in the sass, in large part because of efforts by early 20th-century Muslim economists who envisioned alternatives to conventional Western economics (whose interest-based transactions violate Islamic law). Khan (1999), attempts to give an evolution of Islamic Finance using timeline examination. He posits that there are 3 distinct stages in the evolution of Islamic Finance.

The first was from about 1970 to 1980.

At this point, the concept of Islamic finance was being translated into reality by a group of pioneering Islamic financial institutions, such as Kuwait Finance House, the Islamic Development Bank, Dallas Alberta, and Dare AY-Mall AY-Islam’. Mostly short-term, trade-related, low value- added, and documentation-related businesses were introduced. Serious industry and macroeconomic impediments prevented the further growth and evolution of Islamic finance at this time. The period of 1980 to 2000 witnessed Islamic finance evolving, gaining momentum as a growth industry, and establishing itself as a niche product.

We saw the tenures of deals stretching-? three-year, five-year, and seven-year deals being done-? a lot of covenant-based project finance, and Islamic trenches in big-ticket deals (e.

G. , KEF structured a large deal with Citron on a large Kuwaiti project). A number of new products also came out, there was tremendous improvement in documentation capabilities, and we saw more assistant', bat' salaam, and ajar transactions. In this period, equity opened up as an asset class to Muslims, vying tremendous opportunities for Islamic financial investors.

This period also witnessed the gradual liberalizing of the economies of the OIC world.

In the period of 2000 and beyond, we can look to a focus on infrastructure and venture capital, giving Islamic finance increasing mainstream relevance in the OIC world and a niche- product status in the rest of the world. From stage to stage, this is an industry that is in transition and is evolving along with the markets in which it operates. ' DB, at 2000 World Bank meetings, announced the creation of the first Islamic countries' infrastructure fund, a IIS$I . 5 billion fund targeted specifically at Islamic countries. This fund will hopefully increase the embedded capital of Muslim countries.

In the coming period, Islamic Finance will witness asset serialization, the creation of secondary markets, the manipulation of long-term funds, the creation of new and hybrid instruments, and the achievement of mainstream relevance for this growth industry. Islamic Banking was established to cater for the needs of Muslim customers, as Muslims are obliged to obey the Shari's principles (Islamic Jurisprudence) in all aspects of life. Islamic banks operate worldwide in over 75 countries mostly in Middle East and Southeast Asia, with Bahrain and Malaysia as the biggest hubs.

Islamic banking has established itself as a choice of banking alongside the conventional interest-based banking, and it has been expanding rapidly over the last two decades in both Muslim and non-Muslim countries. That could rival the conventional sector in many countries. Dusk and Abdullah (2006) described Islamic banking as no longer a business entity operated only to fulfill the religious obligations of the Muslim community, but more significantly, it is driving to fulfill the needs and demands of new customers.

. THEORY REVIEW OF ISLAMIC FINANCE Iambi All AY-Karri takes up the issue of philosophical and theoretical underpinnings of Islamic finance in his publication, “ Islamic Banking and Finance: Fundamentals and Contemporary Issues”. According to him, “ The philosophy of Islamic banking and finance is a set of theories and ideas related to its understanding”. He identifies three building blocks related to its understanding. First, the Islamic law (Shari) from which the very idea of Islamic banking has been drawn.

Second, monetary and macro hero which helps explain why Islam considers dealing through the rate of interest as totally unacceptable, and the economy-wide consequences of this prohibition.

Third, banking theory itself helps to explain the nature of Islamic banking and finance as well as to assess its comparative performance. 2. 1 Shari Shari prohibits what is called “ Massif” and “ Gharry”. Massif is involved in contracts where the ownership of a good depends on the occurrence of a predetermined, uncertain event in the future whereas Gharry describes speculative transactions.

Both concepts involve excessive risk and are supposed to foster uncertainty and fraudulent behavior. Therefore the use of all conventional derivative instruments is impossible in Islamic banking.

In the late 20th century, a number of Islamic banks were created to cater to this particular banking market. Islamic teachings in the fields of mulatto, or transactions, prohibit selling of certain quantities of any present goods or service for a different (presumably larger) quantity of the same good or/and service delivered in the future. This is understood to apply to money as well as to all other goods and services.

As a result, any amount of resent money cannot be exchanged for a larger amount of money in future. In addition, there are other rules of transactions that must be applied to insure fairness of dealing to both the contracting parties concerned.

Mainly al-GHB and al-gharry are strictly prohibited. 2. 2 Monetary and Macro Theory The fact that Islamic banking and finance avoids the use of interest-based lending has significant implications to monetary policy. In managing the money supply, the monetary expansion to the level consistent with price stability and expected real growth.

Some Islamic economists propose a 100 per cent required reserve ratio in order to give the authorities absolute control of the money supply and to appropriate all seignior age resulting from monetary expansion to the government instead of banks' shareholders. The fact that the economy is as close as possible to price stability implies that the rate of monetary growth is optimal, and there is no need to divert real resources to monetary use.

Therefore, Parent optimality is assured without problematic deflationary policies. Meanwhile, people can use their cash balances to carry out spot purchases.

Those with insufficient cash balances for their current arches of assets and/or commodities can revert to finance. The rate of interest is replaced by the rate of profit on equity and profit-sharing finance, by markups on credit-purchase finance and by rental rates on leasing finance. While the time-value of money is maintained, there is no need to handle the complicated questions of how to bring the rate of interest down to zero in order to reach the optimal allocation of resources. In case of profit sharing modes of Islamic finance, focus would be on the profitability and rate of return of the concerned investment.

Financial resources would be directed to the most productive investments. This would increase the efficiency of the financing process and also reinforce efficiency in the real sectors. In credit-purchase and leasing modes of Islamic finance, money is not given outright, but rather commodities are given in return for debt obligations. Credit expansion in the face of increasing credit-purchase of assets and commodities would be tied directly to higher demand for assets and commodities, which would have a direct bearing on aggregate supply.

Consequently, credit finance under Islamic finance would be less inflationary in comparison to conventional banking and finance. 2.

2. Behavior of Credit Markets An important part of macro theory relates to the behavior of credit markets. In conventional finance, present money is traded against future money either in integrated debt or in bond markets, where huge sums of debt are traded daily. Debt markets act as an easy conduit to move short-term funds at will from one country to another, more often than not, in reaction to factors that are only nebulously related to economic fundamentals.

Such flows threaten the world economy with the spread of instability that might start in one single debt market in a fashion that economists eave come to call “ contagion. ” In contrast, debt is created in Islamic finance through selling goods and services on credit, which by itself is not readily traceable.

We can visualize the existence of a credit market for each commodity and service in which the demand and supply to buy it on credit determines an equilibrium mark-up rate. Such credit markets would be fully segmented. There is no room for sudden and mass movements of funds.

Possibilities of instability and contagion would therefore be remote and there would be no pressing need to choke capital movements with restrictions. Institutional participants in conventional credit markets carry out huge speculative transactions which most often turn out to a major source of instability.

In contrast, Islamic banking and financial institutions are strictly prevented from carrying out such gambling activities. Thus, it seems reasonable to deduce that destabilize speculative activity would significantly be curtailed in Islamic financial of place.

Change in spending would be reflected directly on change in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces. 2. 2.

Risk-sharing Another important aspect of micro theory is that of risk-sharing. Conventional finance can be likened to a spectator’s game where few skilled players stay in the playground and a big crowd is watching from outside. Islamic finance, meanwhile, is similar to participatory sports, where everyone is playing and no one is merely watching.

In addition, there is a moral side to Islamic finance that seems to be in the back of everyone’s mind. Risk is known to be one of the most important ingredients of making investment.

In Islamic finance, those who finance investment share a good part of the sis with those who carry out actual investment activities. Conventional finance leaves risk to be borne by specialists and traded among them. Banks and financial institutions provide investors with loans guaranteed by collateral.

In this fashion, they keep themselves shielded from certain kinds of risk, like those attached to production, marketing and distribution, and limit their exposure to risk related to collateral only. Islamic finance allows savers who deposit their funds to share with banks the risks associated with choosing the right investment and how successful it will be.

Banks and financial institutions advancing funds share risk with those receiving finance, including producers, traders, and the like. Islamic finance with proper corporate governance allows depositors some influence on banks investment decisions.

The banks and financial institutions can also share the decision-making process as their representatives sit on the boards of directors of firms receiving funds. It, therefore, may be noticed that risk as well as the responsibility for decision- making is spread over a much larger number and wider variety of concerned people.

Risk sharing is balanced by sharing in decision-making. This allows for involvement of a wider section of entrepreneur and investors in economic activities, so that people will eventually feel they are partners rather than spectators.

The benefit of wider involvement goes beyond the feeling of involvement. It adds to the stability of banks. Investment depositors share risk indirectly with firms, while relying on banks for monitoring.

Having the proxy vote of depositors and other investors, Islamic banks, would be capable of influencing the corporate governance of firms in a way that reduces the risks of failure and promotes profits. In other words, the stability of the banking system will reinforce and be reinforced by the stability of the real sector.

The main results of this would be a higher integrity of the whole economic system. 2. 2. 3 Equity Considerations An important aspect of macro theory is equity.

Islamic financial system is basically viewed as private profit-seeking business enterprises that operate according to the market mechanism. By themselves, they cannot reduce, let alone, eradicate poverty. However, if given the right tools, they might contribute to the efforts taken by the whole society in that direction. Kaka proceeds are known to be earmarked for several uses including income and wealth maintenance for the poor.

Income maintenance is provided within narrow limits to those incapable of working and wealth maintenance is provided to the rest of the poor. The latter policy entails giving the poor enough productive assets, to make them more productive, which in turn of and participants in the disbursement of the kaka proceeds. Government and non-governmental organizations (Nags) collecting kaka can deposit part of the proceeds allocated to the poor in special accounts with Islamic financial institutions, o which they may also add a proportion of kaka due on their shareholders' equity.

They might even accept direct payments of kaka and other donations on behalf of kaka payer individuals and philanthropic institutions.

As to income maintenance, Islamic banks can credit the accounts of the prescribed poor with monthly payments. Wealth maintenance can be implemented through the establishment of micro enterprises that would be owned and operated by the poor. While, titles to such enterprises are transferred to the poor, certain measures must be taken to insure hat the new businesses would not be immaturely liquidated to finance consumption outlays for their owners.

The experience of Islamic banking and financial institutions in project financing should come in handy in reducing poverty and increasing equity through proper use of kaka proceeds.

Conventional lending gives utmost attention to the ability to repay loans. To ascertain such ability, it depends overwhelmingly on the provisions of collateral and guarantees. Thus those already rich would have most access to finance. In contrast, Islamic finance providing funds on equity or profit haring basis would be more concerned with profitability and rate of return than with collateral and guarantees.

In an Islamic financial system those who are not wealthy, but have worthy investment projects, may also have appropriate access to finance. Chap (2007) highlighting the benefits of asset backed financing by Islamic banks stated that Asset-based debt should further help by not allowing the debt to exceed the growth of the real economy.

The introduction of such a discipline carries the potential of helping realize notably greater stability, but also greater efficiency and equity in the financial system 2.

Banking Theory An interesting phenomenon in Islamic banking, are the liabilities of Islamic banks of which only demand deposits, placed on the basis of profit and loss sharing, are guaranteed. When such banks face macroeconomic or bank-specific crises, investment depositors automatically share the risk. The bank is less likely to fall bankrupt as bank run is least probable. It can, therefore, be said that an Islamic banking system is relatively more stable than conventional banking.

Banking theory studies finance as a process that runs among three parties: a principal, an agent and n intermediary, where both the principal and the agent Jointly finance a project which is managed by the agent and partly financed by the principal. The success of the project depends on the agent putting a minimum effort. Information asymmetry exists between the agent and the principal, and the latter cannot perfectly monitor the former. An intermediary performing monitoring on behalf of the principal would ameliorate the principal-agent problem.

Islamic banking and finance relates to banking theory in two aspects. First, Islamic banks perform the function of intermediation between fund owners and firms. Banking theory can Justify this role in fashion similar to the role of commercial banking, which intermediates between borrowers and lenders. As monitoring is costly, models containing a costly state- verification problem, C.

V., conclude that an efficient solution to the monitoring problem can be obtained when an agent pools deposits to finance investment simultaneously with credit purchase and leasing finance.

This implies that they are some kind of kin of universal rather than of commercial banks. Banking theory comes again to show that such a role brings extra advantages to Islamic banking. Islamic banks should, therefore, function as universal banks, which are “ large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of the firms that rely on the banks as sources of funding or as securities underwriters. A bank can be exposed to moral hazard when the firm obtaining finance uses the funds for purposes other than those for which finance was advanced.

This could lead to business failure and inability to repay on part of the debtor firm. The bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform. Obviously, adverse selection can be avoided by careful screening of finance seekers.

When a bank provides equity and debt finance simultaneously, it will have more access to information than in a situation when only debt finance is provided.

It could, therefore, be concluded that screening would be more effective and adverse selection less probable with universal banking. In summary, banking theory indicates that Islamic banks should operate as universal banks, and when they do, they would e exposed to lower levels of moral hazard and adverse selection.

Universal banking has recently attracted much writings from both proponents and antagonists. Meanwhile, the arguments leveled against it created much discussion in the beginning but proved unfounded at the end.

It has been credited with encouraging industrialization in pre-war Belgium, Germany, Italy and Japan. This confirms Greenhorn's and Computer's opinions that such form of banking spurs economic growth and helps backward countries to catch up with the developed ones. This has also been confirmed by careful review of historical experience.

More recently, Dad Ring and Hellmann (2001) have introduced financial intermediation into the big push model which has two Parent-rentable equilibrium. They showed that universal banks can induce an economy to move from low to high equilibrium if they are sufficiently large to invest in a critical mass of firms.

The costs of monopolizing the critical mass are reduced, if banks are allowed to own equity that allows them a share in the value they help create by monopolizing the critical mass.

This means that universal banks will find it easier to promote investments in new industries. While providing a sophisticated analytical framework for the behavior of universal banking, Daring and Helmsman's model is a good step towards building a macro theory of banking. Universal banks have been accused of altering the corporate capital structure in favor of debt and against equity, inefficiently combining banking with trade, of concentration to a degree that produces anti-competitive behavior (what came to be known as the organ bank hypothesis).

They have also been accused of benefiting from the inside information about the firms they lend while exercising monopolistic power over access to external finance, leading to conflict of interest between banks and other shareholders, particularly those who have delegated their voting proxy rights.

None of such accusations was found credible. 2. 4. 1 Balalaikas (Sale and buy- back agreement) ABA’ al Nina is a financing facility with the underlying buy and sell transactions between the financier and the customer.

The financier buys an asset from the customer on spot basis.

The price paid by the financier constitutes the disbursement under the facility. Subsequently the asset is sold to the customer on a deferred-moment basis and the price is payable in installments. The second sale serves to create the obligation on the part of the customer under the facility. There are differences of opinion amongst the scholars on the permissibility of ABA’ al ‘ Nina, however this is practiced in Malaysia and the like Jurisdictions.

2. 4. Badminton’s jail (Deferred payment sale) This concept refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties. Like ABA’ al ‘ Nina, this concept is also used under an Islamic financing facility. Interest payment can be avoided as the customer is paying the sale price which is not the same as interest charged on a loan.

The problem here is that this includes linking two transactions in one which is forbidden in Islam. The common perception is that this is simply straightforward charging of interest disguised as a sale. . 4. 3 Biannually (Credit sale) Literally bail unusual means a credit sale.

Technically, it is a financing technique adopted by Islamic banks that takes the form of maharajah unusual. It is a contract in which the bank earns a profit margin on the purchase price and allows the buyer o pay the price of the commodity at a future date in a lump sum or in installments. It has to expressly mention cost of the commodity and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.