

# Fundamentals of Islamic Finance

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REVIVAL | EMPOWERMENT | INTERCONNECTEDNESS

# Session Format

- This may be unfamiliar territory for many
- Intention is to keep it simple
- Objective: become familiar with subject
- New concepts, terminology minimised
- Case Study
- Questions after presentation
- Acknowledgement – the first people of this land

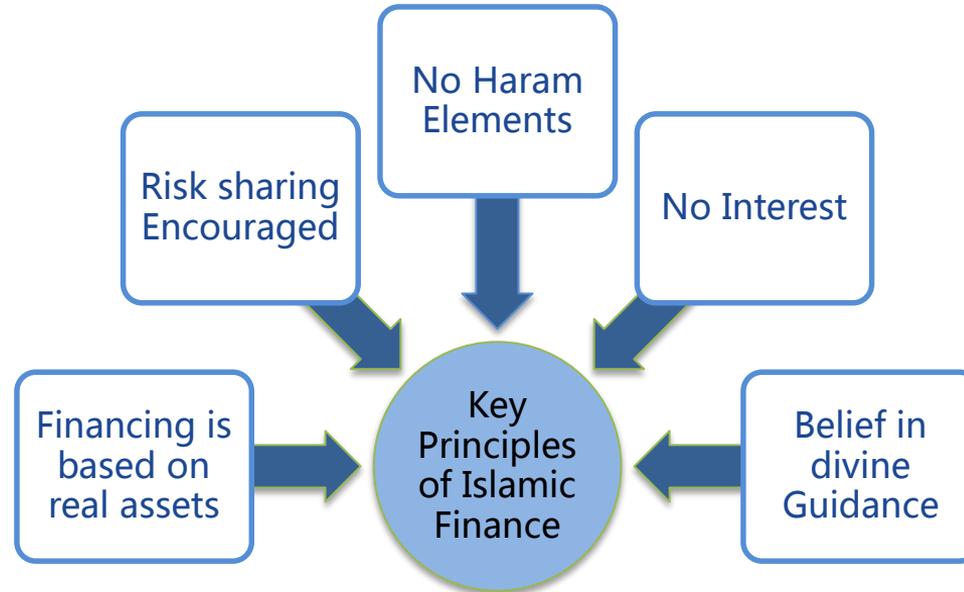
# What is Islamic Finance?

- Put simply, it is the application of faith-based norms and principles derived from the shari'ah dealing with financial transactions and trade practices
- It relies on text, prophetic rules and injunctions, fiqh, practice codes developed from Islamic jurisprudence
- They deal with: the lawful and the prohibited, ethical conduct and legal contracts

# Not so long ago



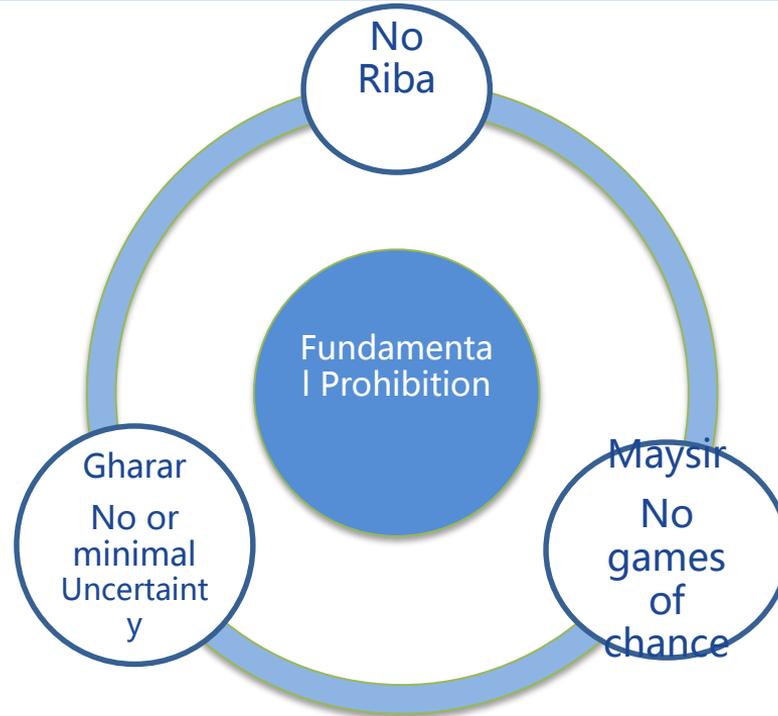
# Constituents



# Beginnings of Islamic Finance

- First modern experiment with Islamic banking initiated by late Dr. Ahmad El-Naggar in 1963 in Mit Ghamr, Egypt
- Help poor farmers: seed; fertilisers; equipment; produce marketing
- Later nationalised by Abdel Nasser
- 1973 Dar al Mal as Islami – set up in Geneva with petro dollars by Sheikh Yemani – emphasis commodity finance
- 1975 Islamic Development Bank (IDB) created
- Mission: provide funds for development projects in the member countries; make it a multi-state central bank for Islamic banks
- Between 1975 and 1990 – focus on replicating traditional commercial banking functions in a Shariah compliant manner.
- By 1980, capital markets, consumer banking and wealth management areas were included
- Two regions with the most dynamic growth have been the Gulf Co-operation Council (GCC) states and Malaysia.

# Basic Principles



# Features

- *Trade rather than money lending*
- *Money a means of exchange*
- *Money not a commodity*
- *Money as bearer of risk*
- *Riba vs. Profit & Loss*
- *Debt vs. Equity financing*
- *Partnership*
- *Social justice*

# Judeo-Christian Practices

- Prohibition of Interest
- Condemned in Judaism & Christianity until Middle Ages
- Rise of Protestantism
- Especially Calvinism
- Catholic church held firmly until 476 CE
- *Interesse*
- *Usura*
- Loss of earnings
- Gain foregone

# Biblical Text

- **New Testament**

- Matthew 25:14-30 Parable of the Talents
- Luke 19:12-27 Parable of the 10 minas
- The Psalms 15:5 Someone who has never lent money at interest ...shall never be shaken

- **Old Testament**

- Exodus 22:25 “If you lend money to My people...exact no interest from them”
- Leviticus 25:35-37 “the kinsman...do not lend him money at advance interest, or give him your food at accrued interest”
- Deuteronomy 23:20-21 no interest to your countrymen ...but interest to foreigners

# Biblical Text & Commentaries

- Jesus drives out the moneylenders
- And Jesus went into the temple of God, and cast out all them that sold and bought in the temple, and overthrew the tables of the moneychangers, and the seats of them that sold doves, And said unto them, It is written, My house shall be called the house of prayer; but ye have made it a den of thieves.” Matthew 2:12-13
- Aquinas
- Plato – The Republic
- Aristotle – Ethics
- Jeremy Bentham

# Look what happens next



# Faith-based; ethical; religious – which one?

- A bit of each
- NOT unique to Islam
- Three Abrahamic faiths share the same values
- Banking first appeared in temples
- As early as 1760, John Wesley (Methodist Church founder) held:
  - Acknowledged relationship between ethics and money
  - Investors custodians of wealth not to harm
- Followed example of the Quakers (Religious Society of Friends)
  - No investment in prohibited activities – tobacco; alcohol; slavery
  - Investment (use of) money confined to religious convictions

# Interest – conceptualisation in Islam

- An increase, growth or accretion
- An “effortless profit or profit that increases the principal amount without putting in any effort”. Also regarded as ‘unearned income
- Unjustified earnings in monetary exchange in which the amount received by the lender is earned without giving equivalent counter-value
- Unjustified advantage. It does not matter whether the loan is a consumption or production loan.
- Riba made up of three elements:
  - Excess or surplus over and above loan capital
  - Excess based on Time
  - Made a condition of contract

# Prohibition of Riba in Islam

Prohibition occurred Gradually

- 1st stage – moral denunciation Rumm 30:39
- 2nd stage – Riba and unethical practices an-Nisa 4:161
- 3rd stage – legal prohibition of riba al-Imran 3:130-2
- 4th stage – absolute prohibition al-Baqarah 2:275-281
  - Allah allowed Trade and prohibited Riba
  - Better to give alms than to demand unjust enrichment
  - Creditor must be paid what is due – without accretion
  - Debt forgiveness meritorious and encouraged
  - Debtor in distress to be given time to repay debt

# Types of Riba

- ***Riba duyun – or the riba that deal with debt***
  - Riba Qard
  - Riba Jahillyah
- ***Riba buyun***
  - Riba Fadhl
  - Riba Nasiah

# Riba - example

## ▪ Types of Riba

### • Riba duyun – dealing with debt

- *Riba Qard (upfront)* - \$100 @ 10%
- *Riba Jahillyah (back end)* - \$100 + 10 if not settled on due date

### – Riba buyun – in sales – unequal exchange of same genus

- *Riba Fadhl (1 Kg of wheat for 2Kg)* – spot exchange
- *Riba Nasiyah (1 Kg of wheat now for 2Kg later)* – deferment in exchange

# Issues – payment of Riba

- Fatwa 26 European Council of Islamic Scholars
- Based on Ikhtilaf
- Housing loans - Muslim minorities
  - Bay al-Taqsid encouraged (sale with deferred payment)
  - Bay al Inah not allowed (buy and immediate resale)
- What if finance unavailable?
  - Can use conventional mortgage – conditions
  - Must be for the buyer
  - Must not have another house(s)
  - Must not have surplus funds with which to buy if alternative exists
- Fatwa based on TWO major considerations

# Juristic Reasons

- First
  - “Necessity turn unlawful matter lawful”
  - Emphasis on *hajah* (need or necessity) individual or community
  - *Darurah* – extreme necessity
  - Surah al-Hajj 22:78 ‘and He has not laid upon you in religion any hardship’
  - *Surah al-Maidah 5:6* ‘Allah does not want to place you in difficulty...’
  - What constitutes *darurah* and for whom?
  - Economic empowerment
  - Social cohesion and advancement
- Second
  - Held – trade with usury and invalid contracts validated by Hanafi scholars M al-Shaybani, Sufyan al-Thawri, Ibrahim al-Nakha’I
  - Also by Ibn Hambal on authority of Ibn Taymiyyah

# Juristic reasons continued

- How should we interpret this?
  - (a) Muslims not obliged to establish civil, financial and political status of host countries
    - Lie beyond their capabilities
    - Allah does not require us to engage in activities beyond our capacity
  - (b) Usury is a concern of the host country over which Muslims have no say or influence
    - What concern us is to hold onto rules governing prayer, food, ethics etc
    - Islam should not be weakened by not advancing financially
    - Benefit should increase not decrease
- Concerning permissibility by Hanafi scholars, TWO conditions apply:
  - The beneficiary of the riba should not be a Muslim
  - No deception is occasioned
- While usurious loans are categorically forbidden, paying interest is ONLY permitted if *hajah* and *darurah* exists

# Issues – Receiving Interest

- Case study & Fatwa al-Azhar
- Egyptian postal authority established:
  - Savings Fund (Sunduq al-Tawfir)
  - Paid Fixed rate return on Savings Certificates
- Scholars
  - M Abduh (d 1904) issued verbal fatwa endorsing practice based on the rule of mudaraba
  - R Ridah (d 1935) published fatwa: held Abduh acquiesced to Sunduq concept; railed against Egyptian banking system
  - A R Sanhuri (d 1971) concurred with Abduh following much vaunted Civil Code
  - Mahmood Shaltut (1960) issued fatwa conferring legitimacy to Sunduq al-Tawfir scheme
  - Longest fatwa issued by M Baqir al-Sadiq (1969) in response to Kuwaiti ministry of awqaf
- Tantawi
  - 1989 issued fatwa titled 'On Some banking Operations'
  - Condones the practice based on juristic reasoning

# Tantawi's Juristic reasoning

- Fatwa divided into 14 sections
- Written before collapse of al-Rayyan Islamic Finance (major fraud and scandal)
- Argues from Qur'an and hadith:
  - Obligation of 'wise men' to approach problem rationally
  - Principle of ijtihad
  - Virtue of avoiding 'fanaticism' (al-ta-assub)
  - Importance of expertise in unravelling arcane subjects
- Ask those if you do not know
- Crystallises issue into THREE categories:
  - Those considered Halal by scholars
  - Those considered Haram by scholars
  - Those about which there is disagreement among scholars
- Sub-continent and Gulf scholars NOT in agreement, although
- Malaysian scholars seem to favour opinion

# Prohibition of Gharar

- Definition of Gharar – generally ‘uncertainty, hazard or chance’
- Types of gharar
  - Gharar fahish (major) e.g. off-the-plan house/unit
    - » Not sure if it will eventuate – developer may go insolvent
    - » What about paying for a flight – pay first then fly
  - Gharar yasir (minor) e.g. fruit, contents of an unopened box
- *Gharar* also refers to undue complexity in contracts e.g. uncertainty in deliverability
- *Shariah* does not permit interdependent contracts e.g. “combining two sales in one”
- What about internet transactions?
- Rule: ‘buyers beware’!!!
- Exercise reasonable caution and conduct

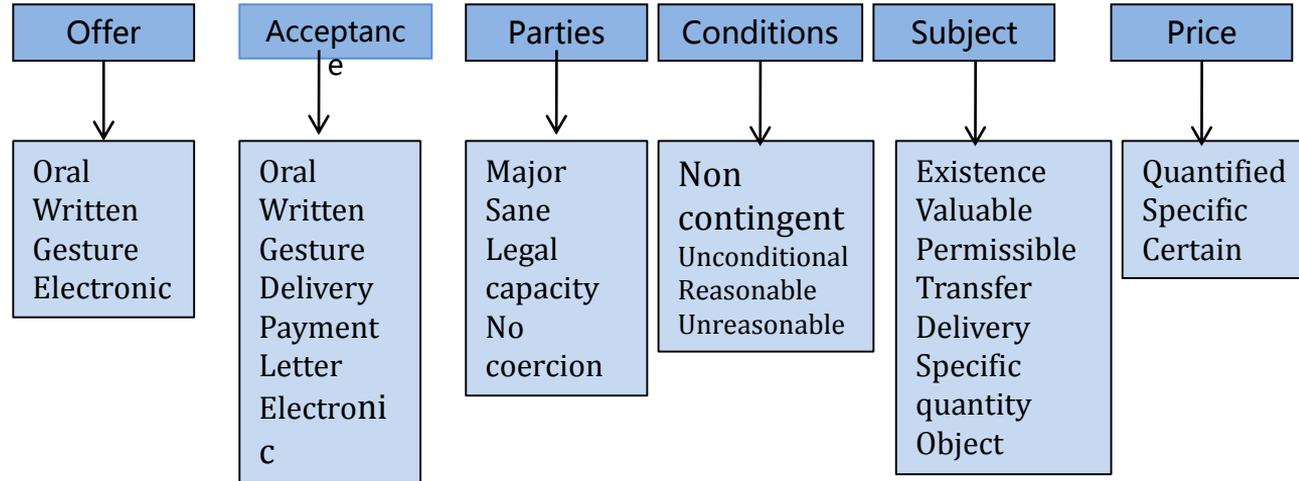
# Gharar – more examples

- Seven cases identified but there are many more
  - Unable to deliver; unknown goods; unknown price; improper description; price not specified; conditional on unknown event/unspecified time; false description
  - Gharar fahish (major)
    - » goods don't exist; undeliverable; not to specification; deferment unknown. Examples: unborn animal; birds in sky; fish in sea; contents of a sealed box; defective engine; white ants
  - Gharar yasir (minor)
    - » Goods seem good but found defective
    - » Motor vehicle – not as expected

# Prohibition of Maysir in Islam

- **Pure Games of Chance - gambling**
- The term *maysir* is also used in the context of pure games of chance
  - Lottery tickets; betting; casinos
- Conditions of uncertainty
  - *O ye who believe! intoxicants and gambling, sacrificing to stones, and (divination by arrows, are an abomination, - of Satan's handiwork (3:90)*
  - *Satan's plan is (but) to excite enmity and hatred between you, with intoxicants and gambling, and hinder you from the remembrance of Allah, and from prayer: will ye not then abstain? (3:91)*
  - *They ask thee concerning wine and gambling. Say: 'In them is great sin and some profit, for men; but the sin is greater than the profit.' They ask thee how much they are to spend; say: 'what is beyond your needs'. Thus doth Allah make clear to you His signs: in that ye may consider (4:219)*

## Valid Sale Conditions



# Housing Finance

- European Council Fatwa 26
- Murabaha
  - Buy and resale
- Al-Ijara (finance leasing)
  - *Al-Ijarah thumma al-bay* – sale of leased asset at the **end** of the lease. Ownership transfer is Not an option given to the lessee. Two contract involved
    - Ijara contract
    - Contract of sale
  - *Al-Ijarah thumma al-iqtina* – lease with an agreed rental paired with a unilateral undertaking by the bank that ownership passes at expiry of lease
    - Also referred to as: *Al-Ijara al-muntahiyah bittamlik* – lease that ends with the Transfer of ownership to the lessee at the end of the contract
    - Commonly – a hire purchase agreement
    - Purchase price is fixed
- Musharaka – partnership based
  - Fixed
  - Declining
- Calculation – see excel presentation

# END

## Thank you