Islamic economics, banking and finance

The normal operations of commercial banks in Western economies do not conform to the religious requirements of the Islamic faith. In this article, Shabbir Dastgir explores the differences and outlines how the worldwide industry in Islamic banking has developed new banking practices

Islamic economics is an approach to economics based on the Islamic faith. Muslims believe in the oneness of God — or Allah — and the infallibility of his message through the Qur'an and other religious texts. Islamic economics is viewed as a science established in the faith, reflecting the Sunnah: the sayings and practices of the prophets and messengers who received and implemented the religious texts. In Islam, the Sunnah of the prophet Muhammad refers to his words and actions in explaining the Qur'an. Muslims look to the Qur'an for the core tenets of faith and to the Sunnah of Muhammad for their application.

Islamic economics is distinguished by two key characteristics:

- a strict prohibition on charging interest for borrowing money
- avoidance of uncertainty in trade and transactions, including gambling

THE MARKET FOR ISLAMIC BANKING AND FINANCE GREW AT ABOUT 17–18% A YEAR BETWEEN 2009 AND 2013

A worldwide industry

These values have contributed to the development of a worldwide industry in Islamic banking and finance, estimated to hold assets worth \$2 trillion in 2014. According to accountants Ernst and Young, the market for Islamic banking and finance grew at about 17–18% a year between 2009 and 2013 and is expected to grow, on average, by nearly 20% a year until 2018. It is concentrated in countries such as Iran, Malaysia and Saudi Arabia but has expanded quickly in recent years to places such as Hong Kong, London and New York. Goldman Sachs, Bank of Tokyo-Mitsubishi UFJ and Societe Generale are some of the global banks involved in Islamic banking and finance.

However, Islamic banking and finance is not without its critics. The main controversy surrounds the extent to which the industry is actually Islamic. Critics argue interest is still charged under various labels, including transaction or service charges, while supporters say interest is not being charged. A middle grouping contends the market cannot evolve independently of the conventional banking sector: this means an element of interest is inherent at present,

Key concepts

money and banking, the rate of interest, uncertainty in transactions but will diminish as the sector matures. The matter is further complicated by the absence of an internationally agreed standard for Islamic economics similar to the Basel Accords, which are internationally agreed regulations covering the conventional banking industry.

Avoidance of uncertainty

The Qur'an refers to uncertainty in terms of gambling, prohibiting it on the grounds that the social cost exceeds the social benefit. The benefit, at best, is a profit for the provider of the gambling service which does not include much productive effort, and perhaps a modest return for the individual. The costs include:

- potentially excessive risks with little or no pay-off
- little 'work' or human effort
- the irrational acquisition and reallocation of money earned without effort — 'luck' being the primary criterion for success
- the potential loss or acquisition of valuable goods
- possible enmity between parties
- distraction from the conventional productive process

For businesses, a key challenge is balancing the large risk associated with uncertainty and the inherent risk involved in trading. Two methods are used to avoid uncertainty in trading:

- the content specified in commercial contracts
- the price mechanism, whereby trade is agreed at 'tomorrow's price'

Products and services which might be sold at 'tomorrow's price' do not give the buyer immediate possession, nor is the price determined exactly. Hence, economic transactions are affected by the uncertain future, but the risk involved in trading is minimised.

Islamic banking and financial products

In the UK, Islamic financial products generally fall into one of two categories: property purchase methods and business support. They are structured to comply with the UK legal and regulatory framework and the City is emerging as a leading centre for their take-up. HM Treasury, the Bank of England and the Financial Services Authority (now the FCA and PRA) have all been instrumental in helping to develop this area.

Property purchase methods

Cost-plus margin

Here the seller declares the original cost and profit margin to the buyer. The bank (the seller) purchases a chosen property at an agreed price and sells it immediately to the buyer, stating the profit margin plus cost. The property is treated as a commodity sold for money rather than an interest-based loan and the client pays in termly instalments (Box 1).

This method is considered an asset-backed transaction and it can be applied to securities, collateralised securities or bonds. **Securities transactions** consist of the bank purchasing goods on behalf of a client and selling them back to the client with a pre-arranged mark-up representing bank profit. The client is able to repay the bank in a single payment or through a series of instalments.

The process works as follows. First the client agrees to purchase a bank-financed

> **Box 1 Example of cost-plus margin**
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> Ali wishes to purchase a small house. The asking price is £100,000. The Islamic Community Bank offers to purchase the property for £100,000 if Ali is willing to buy it from them for £120,000. Ali agrees and arranges termly payments of £400 each month over 25 years.

> **A KEY CHALLENGE IS BALANCING THE LARGE RISK WITH UNCERTAINTY AND THE INHERENT RISK INVOLVED IN TRADING**

asset from the bank at a predetermined price plus mark-up. The bank then purchases the asset, performing due diligence to ensure the best price and quality. The asset is then sold to the client at the predetermined price. In this example, the bank retains ownership of the asset until transfer to client, so the bank rather than the client remains vulnerable to:

- the risks associated with holding a defective asset
- the right of the client to reject the asset if it is not of the agreed quality
- the risks issued with transporting the asset
- the risk associated with not being able to collect the original debt

Therefore, predetermined profit margins exist to compensate the bank for the risks it takes.

Bank-ownership and client lease

A bank-ownership and client lease loan works as follows. The client identifies a property and instructs the bank to purchase it at an agreed price. The bank now owns the property but leases it to the client for a fixed dual monthly payment made up of rent and an additional amount representing

Inside a mosque

Islamic economics avoids uncertainty in trade and transactions, including gambling

Questions and activities

1 Explain why Islamic economics prohibits the charging of interest rates.

2 What two methods have been used to avoid uncertainty in trading?

3 The principal types of UK Islamic financial products are:

(a) property purchase methods

(b) business support

Classify each of the following products as either (a) or (b):

(i) cost-plus margin

(ii) lease financing

(iii) initial capital and subsequent profit sharing

(iv) diminishing partnerships

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purchase of a small share in the property. The arrangement continues until the client's rent and monthly share payments equal the price at which the property was originally purchased plus a modest profit for the bank (Box 2).

Diminishing partnerships

Under a diminishing partnership agreement, the client does not have sufficient funds to purchase a property outright but is able to purchase a small share, say 10%. The bank then purchases the remaining 90% and leases the property to the client, with any interest that arises from the property also shared on a 1:9 basis. The client makes a dual rent-plus-bank-share payment each month until the total amount paid equals the bank's 90% share, at which point ownership is transferred to the client.

Box 2 Example of bank-ownership and client lease

Adam approaches Field Islamic Bank about a studio apartment he would like to buy. It costs £90,000 and is purchased by the bank which now acts as Adam's landlord. Adam becomes a tenant and agrees to pay a monthly rent of £250 for 15 years. At the same time, he agrees to pay an additional £150 each month for 25 years as a means of steadily buying up Islamic Field Bank's share of the property. Both parties sign an agreement to transfer ownership of the property after 25 years, or earlier if Adam increases either of his two payment amounts.

Types of business support

Equity-sharing financial transactions

Financial transactions involving equity sharing involve both the bank and depositors providing capital and labour to any joint venture, from which any profits or losses are shared equally. If a profit is made, it may be distributed in any way by prior mutual consent. In both financial intermediation and financial transaction scenarios, fixed lump sum profits are disallowed, replaced instead by jointly agreed fixed rate returns from any profits earned. In addition, any financial transaction losses are shared strictly in relation to original capital contributions, implying the bank will lose shareholder funds under unsuccessful joint ventures.

Bonds

A more recent development is the introduction of bonds, rather like investment-backed securities. A conventional bond includes a loan which is repaid with interest. An Islamic bond, however, represents shared ownership of an asset or large real estate such as airports or office buildings. Here, the financier again purchases a property on behalf of a client and leases it back for a rental payment. The financier then issues bonds to investors who earn income on the asset that has been purchased. It is common for financiers to establish large companies — special purpose vehicles (SPV) — for the financing of large projects.

Initial capital and subsequent profit sharing

This involves the bank lending an initial capital sum to a firm for a business venture. If the venture is successful, the original sum is repaid together with a share of profit. Both the repayment term and profit share are pre-agreed. If the venture proves to be loss making, the original capital is to be repaid within the agreed repayment term. If this is not possible, the repayment term is extended. If the capital cannot be repaid, it is waived altogether.

The bank draws capital from saver deposits. These may be restricted or unrestricted. Restricted deposits may only be used for lending activities approved by depositors, for example to a particular kind of business or a specified location. Unrestricted deposits may be used at the discretion of the bank. This method shares risk between depositors in the form of a loss

A SUPERVISORY BOARD IS RESPONSIBLE FOR ENSURING BANK PRODUCTS COMPLY WITH THE QUR'AN AND SUNNAH

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Key points

1 Islamic economics is an approach to economics based on the teachings of the Islamic faith.
2 This approach is distinguished by a strict prohibition on charging interest for borrowing money, and the avoidance of uncertainty in trading and transactions (including gambling).
3 To cater for these requirements, a worldwide industry in Islamic banking has developed.
4 There has been some controversy over whether the solutions to the prohibition of interest truly address the issue.
5 Uncertainty in trading is avoided through the details specified in commercial contracts and by having transactions agreed at tomorrow's price.
6 Islamic financial products are based on property purchase methods or business support mechanisms.
7 The legal and regulatory frameworks of Islamic banks are similar to those of conventional banks, but also incorporate a supervisory board to ensure compliance with the Qur'an and Sunnah.

or return on deposits, firms in terms of the return they make and banks with regard to the profit share. For the bank there is also a potential reputational risk from continued losses, which means it must decide carefully which ventures to fund.

Lease financing

The purpose of lease financing is to enable temporary use of an asset through termly payments without owning it. An additional option to purchase the asset on completion of termly payments is possible but must be explicitly stated in a separate contract.

Box 3 Example of lease financing

Company X wishes to raise £100 million to finance a business expansion. It sells land worth £100 million to an SPV, agreeing to repurchase it after 10 years. During these 10 years, the SPV leases the land to company X for an annual rent of £12 million. This allows company X to raise capital, while investors are able to purchase bonds issued by the SPV. Instead of receiving interest on their bonds, investors now receive the initial capital amount plus a rent.

Hence Islamic lease financing consists of two separate contracts: lease and purchase (Box 3). It is also possible of course that a bank may gift ownership of an asset through a client endowment. **Collateralised securities** is the term given to lease financing, diminishing partnerships and project finance.

The legal and regulatory framework

The legal and regulatory frameworks of Islamic banks are much the same as conventional banks, except that they also include a supervisory board responsible for ensuring bank products comply with the Qur'an and Sunnah. The board usually consists of Muslim 'scholars' noted for their knowledge and understanding of Islamic principles and also economics and finance, charged with ensuring bank products are interest-free. The supervisory board will also work with the board of directors to determine appropriate investments, develop new products and manage customer confidence.

Although the supervisory board will not set strategy or make day-to-day decisions, its ability to dictate the Islamic validity or otherwise of bank products makes it a very influential body in an Islamic bank. The supervisory board is also the highest authority in an Islamic bank in that it is ultimately accountable to Allah and not shareholders or the board.

Externally, of course, the supervisory board too is accountable to the legal and regulatory authorities, but internally, the decisions it makes may have an impact on shareholders and depositors. These parties are able to distance themselves from the bank if they do not agree with the views of the supervisory board, resulting in a potential risk to the activities of the bank. Although Islamic banks may have shareholders, who will own nominal amounts of the institution, their primary motive is often to ensure the bank does not engage in prohibited business, such as trade in alcohol, pork or offensive (rather than defensive) military weapons.

Conclusion

From a consumer perspective, the objective of Islamic banking is to avoid interest. The examples above illustrate the current methods being employed to meet this need. The Qur'an and Sunnah do not stipulate

FROM A CONSUMER PERSPECTIVE, THE OBJECTIVE OF ISLAMIC BANKING IS TO AVOID INTEREST

a complicated model for the prohibition of interest. Rather, a number of general principles including justice, equality, fairness and balance or moderation are stated, with a strong emphasis on their application. Of course, such values have also been developed in mainstream economics, but they are seen as especially pertinent to Islam.

Individuals are encouraged to act to the best of their ability in carrying out the principles, but such that no person is presented with a burden he or she cannot bear. A transaction is prohibited if the social cost is greater than the social benefit, thereby producing a net decrease in social welfare. Restrictions exist to ensure transactions remain lawful — some will be prohibited, while others, such as the drawing up of a legal contract as a prerequisite for exchange, are intended to reduce the uncertainty in an economic transaction. Obligations, such as charitable giving, encourage people to be proactive in seeking the betterment of society and community.

The legal sanction in mainstream economics usually ensures prohibitions, restrictions and obligations are enforced. Islam places a greater emphasis on life after death and the subsequent pleasure or punishment of Allah that this will bring. This instils a sense of ethics and accountability in individuals, and a commitment to obligations such as selflessness and consideration for others that must always be considered — including in economics, banking and finance transactions.

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