

A Descriptive Analysis of Islamic Finance as a Possible Alternative to Conventional Investment Management

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Abstract

In the Western World, prior to the financial crisis, very few people know or understand Islamic Finance or Islamic tools in the financial world. It can be seen that since 2008 every week at least one article would be published in specialized economic and financial presses on the niche market of Islamic Finance. Some columnists predict that Islamic Finance will be the only resource that will save the world from the current financial crisis. One could even read press release from the Vatican saying that the Pope Benedict XVI encourage banks to look at the rules of Islamic Finance to restore confidence amongst their clients at the time of global economic crisis¹. What a sudden infatuation for a tool that was almost not known outside the Islamic World until recently. In this report, I will give an overview of Islamic Finance and ponder on questions of the authenticity of this growing financial tool within the investment community. I will also present the different tools used in Islamic Finance including Takaful insurance, and present the way they work and how they differ (if they differ at all) from “regular” conventional financing. The final part of the paper will review the viability of meeting the requirements to be deemed as “Islamic Finance.”

What Is Islamic Finance

Islamic Finance is - in accordance with the Islamic law – based on two main principles:

1. The prohibition of Interest

2. The social responsibility in investment by investors

It focuses more on linking the financial profitability of an investment with the outcome of the project.

¹ Bloomberg.com,
www.bloomberg.com/apps/news?pid=newsarchive&sid=aOsOLE8uiNOg



Islam forbids personal and commercial transactions using interests (riba) as speculation (gharar) or any other exposure to financial games of chance. Hence, we are indeed automatically facing some major problems here:

- I. How can you finance a project without credit?
- II. Whom will give you credit without interest?
- III. Could we not consider the stock exchange market as global casino (risky venture)?

The rule in Islam is clear; you should not exchange any goods of the same value with any kind of advantage or interest.

The first question then arises concerning one aspect of Islamic Finance - the time value of money. Take for example the following situation: Company X lends company Y \$200,000 today and advised the money would be repaid to company X in ten years. Would the money have the same value? The same power? Not based on the rule of one dollar today is better than two dollars tomorrow². If so, the great art form of Islamic finance will transform capitalist tools and change to the direction and recommendations of the financial world. In reality it more likely means that to stay within the laws of Islam, Islamic banks have developed legal mechanisms that circumvent the prohibition of lending with interest but still manage to maintain the value of money.

A Little Bit Of History

One would be surprised to know that Islamic Finance or banking is a tool recently developed in Islamic countries and in particular in the Arab world. The first Islamic bank opened in Egypt, in

² Brian Kettell, *Islamic Finance in a Nutll*, John Wiley & Sons Ltd, 2010

1963, under Abdel Nasser regime. It had a rapid and great success mainly because they invested in development projects that had a direct impact on the handicapped poor population. It is also interesting to note that traditional Christian finance is based on the same values as Islamic finance. In Europe, during the Middle Age, only Jews were allowed in cities as bankers because Christian citizens could not give loans with interest. Strictly speaking it meant that because Christians were not able to deal with interest, they would “hire” other people to do it for them. Again, is it not evidenced that interest is a must for a developing society, or a must for maintaining the value of one’s money?

Outlaw Investments In Islam

Investment companies dealing with Islamic finance advise the public that they respect all the rules of financing investment projects as required by Islam; however: as investments are spread across the world there are likely some areas of activities that are them-selves illegal in Islam that become incorporated into the investment practice. For examples: Areas related to alcohol, pork meat /food and hazardous games are not permitted in Islam, and it is forbidden to invest in projects having any connection with these sectors. It is also the same for any business having to do with prostitution, pornography or any human degrading business. All of these of course make sense and seemed perfectly ethical. But are they feasible in terms of avoidance? At an individual investment level, yes, one can decide, based on available information in which kind of business one is willing to invest, but at institutional /organizational levels multinational holding entities get to control where financial capital will be invested and the spectrum is so large. As exposed by the housing bubble melt down which did not just affect the US (but the entire world) as assets were sold several times over to various groups around the world. How can the average investor ensure that in today’s world his investment is safe from involvement in sectors deemed illegal within Islam?

Islamic Finance In Today’s World

The value of Islamic Finance in the world was estimated to be between 700 and 800 billion US dollars in 2009-2010 and is expected to reach 1.3 trillion in 2011, according to the forecast published by Islamic Banking Institutions. What would happen if the world’s Muslim population increased their demand for Islamic Financial tools? What is sure is that the world largest banks will be happy to oblige and to do so; they will have to customize their portfolio offers to cover all customers bases, and also ensure that all are pleased and offered plans that will meet their specific requirements.

For the last ten years, the Islamic Banking sector has been in continuous expansion benefiting from two major developments:

- I. The attack of the World Trade Center and the implicit consequences of the attack in terms of (war in Afghanistan and war in Iraq). Both wars had the effect of developing and strengthening Arab and Islamic identities.

- II. The financial Crisis: many people lost faith in “capitalism” and free market system and wanted to try other mediums of investment that appear healthier, and with minimum risks to investors.

For example, in Europe, the UK leads the way with the rapid adoption of legal and economic measures to promote the emergence of Islamic finance. The first Islamic Bank opened in London in 2004. Similarly, in Germany this new market is strongly being taken into consideration upon understanding that opportunities for safer ways of making money exists in the sector. This trend also continues in other industrialized Nations mainly to attract Muslim investors.

Additionally the global sector of Islamic insurance continues to show rapid growth appealing to both Muslims and non-Muslims alike. The industry is expected to grow by 15-20% annually³, with trading capital volume expected to reach USD12 billion in 2011.

Types of Islamic Credit Tools

I. Murabaha

It is a contract of sale with a margin price known and defined between the buyer and the seller. It can be direct: transaction between a buyer and a seller, or indirect: the seller gives the order and a third person will be the intermediary between the seller and the buyer. Islamic banks could be the intermediary i.e. the bank buys from the seller and resells to the buyer with a margin price previously agreed between the seller and the buyer.

II. Ijarah

The Ijarah or leasing is a lease of property with a promise of sale to the tenant. It is a relatively new financing technique which involves three main actors:

The Supplier (manufacturer or seller) of the property

The Lessor (in this case the bank that will buy the property and rent it to its client

The Renter who leases the property, reserving the option of acquiring it at the end of the lease

What we can see is that the right of ownership belongs to the bank during the whole period of leasing while the right to enjoy up the product belongs to the renter

At the end of the contract the following three scenarios are possible:

The renter is obliged to acquired the property

³ Ernst and Young, World Takaful Report 2011, Transforming Operating Performance, April 2011

The renter has the choice to buy or return the asset
The renter opts for a second lease of the property (renewal of contract)

Ijarah works under some conditions: 1. the purpose of the lease must be known and accepted by both parties. 2. The lease must be for durable goods (not for perishable goods) and 3. The rental period, the payment period as well as the rent should be fixed and cannot be changed

III. Salam

The Salam can be defined as a contract of sale with deferred delivery of goods. Contrary to Murabaha, the bank does not act as the seller of the goods but as a buyer with cash payment of the goods that will be delivered eventually by its partner.⁴ The rule of the Shari'a in principle prohibits any commercial transaction in which the object is nonexistent at the time of the conclusion of such a transaction

However, some business practices that do not meet this condition are tolerated because of their necessity in people lives. Then, we can ask: what then is the sense in all the` rules if under the doctrine of necessity, the rules can be ignored.

IV. Istina'a

It is an enterprise contract in which one party asks another to make or build for him a product agreeing that payment will be made in advance, periodically or upon completion of such project. This practice is very close to Salam but here, the product will have to be made (as opposed to being a finished good as in the case of Salam). This form of financing allows Islamic Banks to finance constructions of houses, buildings, and other commercial structures

V. Mushraka

The musharaka is a partnership between two parties or more in the capital of a company, project or operation through a distribution of profits (it can be loss or gain) in agreed proportions. It is based on the morality of the client, the relationship of trust and the profitability of the project operation.

As practiced by Islamic banks, musharaka occurs most often in the form of a contribution to the financing of projects or specific operations proposed by the customer. The Bank participates in financing the project and receives part of the accruing benefits there from as a partner in the project or as a co- owner of the property

⁴ Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons, Ltd, 2007

The Musharaka financing because of its flexibility and participatory nature has several advantages in Islamic Banking, financing, and also for partnership agreements deemed acceptable within Islamic commercial rules

Islamic Insurance

Known as Takaful Insurance (cooperative risks sharing). It is a type of insurance that follows the principles of Islam as directed by the Quran. The traditional and practical aspect of insurance is forbidden in Islam due to the fact that, there are chances of making money from luck (qimar) and interest (riba). Takaful was however founded on the concept of cooperative principle and on the principle of separation between funds and operations of shareholders, thereby passing the ownership of takaful (insurance) fund and operations to the actual policyholders

How General Takaful Works

Two methods often utilized:

The first method is Mudarabah model where the parties involved enter the contract for indemnification and share of the underwritten results. The surplus is shared between both the company and the involved parties at a predetermined ratio. This model allows all the parties to share from underwritten results and the company can re-invest those revenues. This model still poses some problems to Islamic law)How can the ability of the company to share “surplus” be comparable to mutual contract for assistance and protection as required by Islam?) This model does not meet the requirements of the concept of donation, because, at the end of the deal, all the participants are actually “profit sharing.” And such is unacceptable in shari’a law in Islam

The second type of takaful is wakala, which contends that the operator only earns a fee for services plus an upfront deductible fee. The operator also earns a share of the investment’s profit but does not share from underwritten results. As this is relatively new model at providing insurance based on religiously correct methods, it has not been fully implemented or proven commercially viable⁵.

Criticism of Islamic Finance

Some Muslim critics maintain that the Islamic banks hide the payment of interests behind legal tricks. They compare the use of Islamic Finance to that used by European bankers in the middle Ages, A practice which allowed for charging interest on money but was however against the teaching of the church. Other Muslim’s contended that the interest is only hidden or relabeled by Islamic banks. They argued that the principle of charging a premium based on a given amount of money borrowed for certain period of time is de’facto profiteering. For example, Mohammad Saleem contends that these practices are only “financial smoke and mirrors”⁶ Additionally he contends that these banks are engaging in deceptive and dishonest banking

⁶ Saleem, Mohammad, *Islamic Banking – a 300 Billion Deception, 2006, Xlibris*

practices in the guise of Islamic Banking and Finance. Another such example stems from Mahmoud El-Gamal of Rice University; he argued that Islamic finance has its fallacies in the notion that in many cases, the so called “interest free” loans have market values based on the return on investments with such cases as the Bahrain’s Islamic Bonds which pay a yearly interest rate of 4%.

It is believed that the idea behind Islamic banking should be to provide quality financial products at a fair price; however, those behind this type of banking are typically not interested in efficiency or fair pricing. It is argued that their emphasis is on securing the approval of the Shari’a Supervisory Boards. The concept of financial management deals with the theory of credit and risk, both of which are against the idea of Islamic finance. It is argued that the only way which any company can continue to ensure fundamentals of Islam is to increase the costs of borrowing in one way or the other, while charging zero interest rate. It however remained to be seen if the ever exiting competition from the conventional banks and other financial Institutions will allow the eventual survival of Islamic Banking and Finance. In truth, the cost associated with transactions in Islamic finance is actually like the exact opposite of the real teaching of the Quran, (as far as financing is concerned) because, in most cases, the poor and the middle-class Muslims end up paying more for the same money borrowed or insurance purchased from Conventional mediums. Whereas; the core majority of the teaching and writing on financing in Islam is that it is harmful to the poor, and therefore prohibited. As a result of this, In Islam, it is decreed that those needing financial assistance should receive charity and that those who are able to should make it a point of duty to protect the poor. Interestingly however, this is certainly not the obvious result from today’s Islamic banking.

Additionally, interchanging the idea of risk and chance is incorrect as they are two entirely differently things. In principle, insurance products and futures contracts are the opposite of risk or gambling. Insurance, in most cases, is about controlling and limiting one’s risks, not to profit from the chance that something will happen. If the Quran teaches protection of the poor and of those in need, then why should People have to pay more for Islamic Insurance? Was it the intention of the Quran to have the people who need assistance the most pay more for such services?

Gamal argues that it is not the form of financing that causes problems under the principles of Sharia law, but the motive of gaining excessive profits. It is believed this was the real point of the Quran against “riba”⁷. He argued that it is possible that financing organizations such as mutual savings and loans and mutual insurance companies, where borrowers are also shareholders in the bank or insurance company, may still be perfectly acceptable even if they charge fixed interest or use traditional insurance contracts, because, they are non-profits and the benefits are shared by all members. The concept that Allah wanted lenience for Muslims is actually not seen with today’s various Islamic financial schemes (in terms of their modus operandi). Majority of the Islamic financial outfits actually cause the poor to be exploited or

⁷ El-Gamal, *Islamic Finance Law, Economics and Practice*, Rice University, 2006, Cambridge Press, New York

charged extortionate rates for the same products⁸ offered by non – Islamic financial institutions at more competitive rates. There are also critics within Islam who express concerns over any types of insurance. The first of these explains that in Islam, trust should only be put in Allah for protection and not in an insurance company or program.

Conclusion and Opinion

After the analysis of Islamic Finance, I arrived at the conclusion that, the main input of Islamic Finance is to convert “normal financing” into enforced Halal financial products, while abstaining from any religious dispute in analyzing the benefits of both types financial of tools, it is obvious that Islamic finance has very little weight. Since the Industrial Revolution, the global economy as a whole has been based on capital markets and loans to assist with development and growth. This idea had allowed countries of the World to manage their respective economic development as seen in the examples of Countries like the United-Kingdom, USA and many other Western European Nations. The former communist countries that refused private ownership of capital and other factors of production are still today lagging behind their capitalist counter parts even many years after the collapse of communism.

The belief that Islamic Financial tools are magic tools that will save the World finance from cracks and crisis is just an illusion. This is because; the tools used in Islamic finances do not differ in principle from the tools of the Western type financial institutions. From the analysis completed here, we can see that, there seemed to be the case of the same products offered with name changes and presented differently⁹ By Islamic banks and other financial institutions we could even raise the question:”Does Islamic Finance really exist?” The aim here is not to criticize Islamic Finance or built a statue of Western Financing, but rather, to reiterate the point that, it is certain that capitalist finance has to learn from its mistakes and especially, from the recent global financial crisis. It is obvious that, there are urgent needs for reforms within the western idea of banking and finance and Government regulations still appear to offer the safest route to prevent future crisis.

As presented at the beginning of this paper, the central feature of Islamic Finance is the banning in the Holy Koran, of any forms of interest (riba). Here, it is my opinion that the inequality between the strong and vital role of interest in the modern financial and economic system and the disapproval of same in Islam has Challenged Muslin scholars and thinkers to explore new ways of profitable commercial banking. However, this seems unachievable without compounding the problem of additional financial burden on the people that should be protected most, which in effect means yet another violation of the Koran financial rules.

⁸ Bleher, Sahib Mustaqim, Selling halal mortgages is like selling porkies with interest, Q-News, 2004

⁹ Timur Koran, Islam and Mammon: The Economic Predicaments of Islamism, Princeton University Press

In my opinion, due to the impracticality of running a profitable financial outfit that will be 100% independent of integral factors like interest, risk taking, speculations etc as demanded by the Holy Koran, financial products packaged according to Islamic laws should not be used as sound investment techniques by individuals or corporations. Capital inputs would be much better invested in various improved financial tools that have been proven as good and profitable mediums of economic gains and empowerment. Islamic finance, in its current state, is outdated and a seeming marketing ploy that will not likely be viable financial management tools of the future. In other words, unless and until the rules and regulations guiding Islamic finance are changed, it cannot be seen as appealing to serious investors of any religious persuasion as a real medium of financial empowerment or financial gains, and thus will not likely be deemed by many as a suitable alternative method of investment, and financial management.

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