KCA UNIVERSITY

SECTION 3: FINANCIAL MANAGEMENT

ISLAMIC FIANCE

The Concepts and Principles of Islamic Finance

Islamic finance is a financial system that operates according to Islamic law (which is called *sharia*) and is, therefore, sharia-compliant. Just like conventional financial systems, Islamic finance features banks, capital markets, fund managers, investment firms, and insurance companies. However, these entities are governed both by Islamic law and the finance industry rules and regulations that apply to their conventional counterparts.

Principles of Islamic finance

Islamic economics is based on core concepts of balance, which help ensure that the motives and objectives driving the Islamic finance industry are beneficial to society.

- **Balancing material pursuits and spiritual needs:** In Islam, economic activity conducted according to sharia is, itself, an act of worship. Muslims believe they will be granted rewards or merits for sharia-compliant economic activities just as they're rewarded for worshipping Allah (God). The key to achieving such rewards is to find balance between economic activities and spirituality. In other words, a follower of the faith shouldn't focus on business success so much that he neglects worship, for example.
- **Balancing individual and social needs:** A Muslim is expected to consider society in general when enjoying the bounties granted to her by Allah. These considerations include promoting justice in all economic activities, remembering that all people have mutual responsibility for all others, and using the earth's resources wisely. Islam promotes moderate consumption and prohibits extravagant spending. That word *extravagant* applies both to spending too much on acceptable products and activities and to spending any money at all on prohibited ones. Even though the supply of resources in this world is limited, Muslims believe that Allah has provided everything that humans need (and in an appropriate quantity). Islam ensures that humans use resources wisely by placing limits on demand through the directive to be moderate in consumption.
- **Requiring zakat:** To promote justice related to the distribution of wealth, Islam imposes a property tax called *zakat*. Every Muslim who meets certain criteria regarding the accumulation of wealth must pay zakat, which is distributed to people in need. By taxing the property of people who acquire wealth and distributing that tax to people in need, Islam promotes the socially responsible distribution of wealth.
- **Prohibiting riba (interest):** Islam prohibits interest-based transactions. No individual or business entity should hoard money in order to earn interest; instead, people and businesses should use money (keep it in circulation) to support productive economic activities — those that create investment, trading, and jobs. The returns of successful economic activities are then distributed to the different parties involved; wealth is shared.
- **Encouraging shared risk:** Islamic finance encourages risk-sharing in economic transactions. When a risk is shared among two or more parties involved in an economic activity, the burden of the risk faced by each party is reduced.

The prohibitions

The following activities are prohibited:

- Charging and receiving interest (*riba*). The idea of a lender making a straight interest charge, irrespective of how the underlying assets fare, transgresses the concepts of risk sharing, partnership and justice. It represents the money itself being used to make money. It also prohibits investment in companies that have too much borrowing (typically defined as having debt totalling more than 33% of the firm's average stock market value over the last 12 months).
- Investments in businesses dealing with alcohol, gambling, drugs, pork, pornography or anything else that the Shariah considers unlawful or undesirable (*haram*).
- Uncertainty, where transactions involve speculation, or extreme risk. This is seen as being akin to gambling. This prohibition, for example, would rule out speculating on the futures and options markets. Mutual insurance (which relates to uncertainty) is permitted if it is related to reasonable, unavoidable business risk. It is based upon the principle of shared responsibility for shared financial security, and that members contribute to a mutual fund, not for profit, but in case one of the members suffers misfortune.
- Uncertainty about the subject matter and terms of contracts – this includes a prohibition on selling something that one does not own. There are special financial techniques available for contracting to manufacture a product for a customer. This is necessary because the product does not exist, and therefore cannot be owned, before it is made. A manufacturer can promise to produce a specific product under certain agreed specifications at a determined price and on a fixed date. Specifically, in this case, the risk taken is by a bank which would commission the manufacture and sell the goods on to a customer at a reasonable profit for undertaking this risk. Once again the bank is exposed to considerable risk. Avoiding contractual risk in this way, means that transactions have to be explicitly defined from the outset. Therefore, complex derivative instruments and conventional short sales or sales on margin are prohibited under Islamic finance.

The permitted

As mentioned above, the receipt of interest is not allowed under Shariah. Therefore, when Islamic banks provide finance they must earn their profits by other means. This can be through a profit-share relating to the assets in which the finance is invested, or can be via a fee earned by the bank for services provided. The essential feature of Shariah is that when commercial loans are made, the lender must share in the risk. If this is not so then any amount received over the principal of the loan will be regarded as interest.

There are a number of Islamic financial instruments which can provide Shariah-compliant finance:

- *Murabaha* is a form of trade credit for asset acquisition that avoids the payment of interest. Instead, the bank buys the item and then sells it on to the customer on a deferred basis at a price that includes an agreed mark-up for profit. The mark-up is fixed in advance and cannot be increased, even if the client does not take the goods within the time agreed in the contract. Payment can be made by instalments. The bank is thus exposed to business risk because if its customer does not take the goods, no increase in the mark- up is allowed and the goods, belonging to the bank, might fall in value.
- *Ijara* is a lease finance agreement whereby the bank buys an item for a customer and then leases it back over a specific period at an agreed amount. Ownership of the asset remains with the lessor bank, which will seek to recover the capital cost of the equipment plus a profit margin out of the rentals payable.
- *Mudaraba* is essentially like equity finance in which the bank and the customer share any profits. The bank will provide the capital, and the borrower, using their expertise and knowledge, will invest the capital. Profits will be shared according to the finance agreement, but as with equity finance there is no certainty that there will ever be any profits, nor is there certainty that the capital will ever be

recovered. This exposes the bank to considerable investment risk. In practice, most Islamic banks use this is as a form of investment product on the liability side of their statement of financial position, whereby the investor or customer (as provider of capital) deposits funds with the bank, and it is the bank that acts as an investment manager (managing the funds).

- *Musharaka* is a joint venture or investment partnership between two parties. Both parties provide capital towards the financing of projects and both parties share the profits in agreed proportions. This allows both parties to be rewarded for their supply of capital and managerial skills. Losses would normally be shared on the basis of the equity originally contributed to the venture. Because both parties are closely involved with the ongoing project management, banks do not often use Musharaka transactions as they prefer to be more 'hands off'.

- *Sukuk* is debt finance. A conventional, non-Islamic loan note is a simple debt, and the debt holder's return for providing capital to the bond issuer takes the form of interest. Islamic bonds, or *sukuk*, cannot bear interest. So that the *sukuk* are Shariah-compliant, the *sukuk* holders must have a proprietary interest in the assets which are being financed. The *sukuk* holders' return for providing finance is a share of the income generated by the assets. Most *sukuk*, are 'asset-based', not 'asset-backed', giving investors ownership of the cash flows but not of the assets themselves. Asset-based is obviously more risky than asset backed in the event of a default.

Difference between Conventional and Islamic banking

Conventional Banking	**Islamic Banking**
Money is a commodity besides medium of exchange and store of value. Therefore, it can be sold at a price higher than its face value and it can also be rented out.	Money is not a commodity though it is used as a medium of exchange and store of value. Therefore, it cannot be sold at a price higher than its face value or rented out.
Time value is the basis for charging interest on capital.	Profit on trade of goods or charging on providing service is the basis for earning profit.
Interest is charged even in case the organization suffers losses by using bankâ€™s funds. Therefore, it is not based on profit and loss sharing.	Islamic bank operates on the basis of profit and loss sharing. In case, the businessman has suffered losses, the bank will share these losses based on the mode of finance used (Mudarabah, Musharakah).
While disbursing cash finance, running finance or working capital finance, no agreement for exchange of goods & services is made.	The execution of agreements for the exchange of goods & services is a must, while disbursing funds under Murabaha, Salam & Istisna contracts.
Conventional banks use money as a commodity which leads to inflation.	Islamic banking tends to create link with the real sectors of the economic system by using trade related activities. Since, the money is linked with the real assets therefore it contributes directly in the economic development.

Salam

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. The contract of Salam creates a moral obligation on the Salam seller to deliver the goods. The Salam contract cannot be cancelled once signed.

Istisna'

Istisna' is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him with material from the manufacturer, the transaction of istisna' comes into existence. But it is necessary for the validity of istisna' that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them

Prohibition of riba (interest)

Islam prohibits interest-based transactions. No individual or business entity should hoard money in order to earn interest; instead, people and businesses should use money (keep it in circulation) to support productive economic activities — those that create investment, trading, and jobs. The returns of successful economic activities are then distributed to the different parties involved; wealth is shared.

Reasons for the Islamic prohibition of interest (riba)

1. Taking interest implies taking another person's property without giving him anything in exchange. The lender receives something for nothing.
2. Dependence on interest discourages people from working to earn money. Money lent at interest will not be used in industry. Trade or commerce, all of which need capital, thus depriving society of benefits.
3. Permitting the taking of interest discourages people from doing good. If interest is prohibited people will lend to each other with goodwill expecting nothing more back than they have loaned.
4. The lender is likely to be wealthy and the borrower poor. The poor will be exploited by the wealthy through the charging of interest on loans.

Growth of Islamic financial services in Kenya.

Islamic finance is developing at a commendable rate in Kenya since its inception. Within one year after their launch the two fully fledged banks commanded 1% of the gross assets in the banking industry. Gulf African bank managed to break even two years after it was launched while First community bank took three years to report profit. Their conventional peers that were established at the same time are still struggling to register any meaningful profit.

Riding on the success of their banking products the two Islamic banks have diversified their financial services to include insurance and investment banking services. Both banks have fully owned subsidiaries of Takaful (Islamic insurance) businesses that were launched in early 2011. In March, 2012, First Community bank launched FCB capital, the first Islamic investment bank which is geared towards offering its customers investment opportunities that are in tandem with their faith.

This exponential growth has been facilitated by a number of factors which we shall discuss below

Niche Market

Islamic banks curved for themselves a market niche that was previously untapped. Muslims shunned interest based banking since they could not reconcile their economic decisions and their faith under the interest based banking and were left with no option but to remain unbanked. Islamic banks filled this gap and the community was naturally drawn towards them.

High level of trust

Islamic banks have *Sharia* Supervisory boards that ensure the products offered by the banks are *sharia* compliant. The boards also audit the products to ensure that Islamic principles are implemented. The boards are made up of Islamic scholars who are well versed with *fiqhula muamalat* (Islamic jurisprudence) and Islamic law in general. They are well known to the Muslim community and they command a strong following.

Government support

Kenya has positioned itself as the hub of Islamic finance in eastern and central Africa. Kenya was the first country in eastern and central Africa to amend the banking laws to accommodate Islamic finance. In the 2010-2011 budget former finance minister proposed further amendments to the banking Act and the Central bank laws to facilitate the flourishing of Islamic transactions in the country. Although, the Islamic finance sector still faces teething legislative challenges, the attitude of the government in embracing the idea has been positive

Highly customised products

Islamic banks also offer highly customised products that are hinged on their target customers' faith and which facilitate Muslims to perform their religious obligations.

One such product is the *Hajj* or *Labeyka* account which enables Muslims to save for the performance of annual pilgrimage to Mecca. Hajj or Pilgrimage is one of the pillars of Islam and must be performed at least once by those with the means. It is usually a life dream for Muslims and therefore the uptake of such products has been high. The banks have also come up with products that are geared towards empowering the vulnerable in the society like women and children. The *Annisaa* account enables women to save for their future. These products offer higher returns than the other accounts.

Low risk products

A study commissioned by the International monetary fund found that Islamic banks fared better than the conventional ones in the aftermath of the recent financial crisis. In the study "The effects of the global crisis on Islamic and conventional banks: A comparative study" the authors concluded that Islamic banks contributed to financial and economic stability during the crisis.

Gharar (uncertainty in the subject matter) and *Meysir* (Speculation) are forbidden. Thus transactions that are considered to have excessive risk due to uncertainty are not allowed. Falling in this category are derivatives such as forwards, options and futures. For this reasons, Islamic banks are more resilient to crisis. This model appeals to the majority of people who want stability and are generally risk averse.

<u>Challenges facing Islamic finance-</u>

In spite of the growth potential in Islamic banking, there are several challenges facing Islamic Financial Institutions.

— Shortage of experts in Islamic banking: The supply of trained or experienced bankers has lagged behind the expansion of Islamic banking. The training needs affect not only Arab domestic banks, both Islamic and non-Islamic, but foreign banks as well.

— Absence of accounting (and auditing) standards pertinent to Islamic banks: Uncertainty in accounting principles involves revenue realization, disclosures of accounting information, accounting bases, valuation, revenue and expense matching, among others. Thus, the results of Islamic banking schemes may not be adequately defined, particularly profit and loss shares attributed to depositors.

— Lack of uniform standards of credit analysis: Islamic banks have no appropriate standard of credit analysis. Similarly, there is a widespread training need involving related aspects such as financial feasibility studies, monitoring of ventures, and portfolio evaluation.

— Potential conflicts with central banks: Islamic banks have been established as separate legal entities; therefore, their relationships with central banks and/or other commercial banks are uncertain. Problems may be further aggrivated when an Islamic bank is established in a non-Muslim nation, and is subject to that nation's rules and requirements.

— Potential conflict between domestic banks, foreign banks, and Islamic banks: It appears that domestic banks and foreign banks will experience continuing difficulty in adopting Islamic banking practices until they can become more confident of the results of investing ventures.

— Instruments that meet the demand of specific investment requirements: One of the biggest challenges facing institutions is the provision of short-term investment instruments. Several institutions have tried to develop high quality short-term instruments, but have been hampered by their ability to generate assets, by their credit ratings, and by liquidity.

Standardizations in Islamic finance

The lack of standardisation in Islamic finance is a significant constraint on the industry's growth and we expect progress to be slow given the scale of the challenge, Fitch Ratings says. Greater harmonisation of sharia codification within and between jurisdictions is often cited as a limiting factor. But we believe it is just one of five overlapping areas where greater standardisation and codification will be needed if Islamic finance is to gain wider acceptance among regional and international investors.

As well as sharia, we see product structure and documentation, supervisory and regulatory frameworks, law and dispute resolution, and financial and accounting reporting as the main areas where standardisation would be advantageous. In some cases, there is still little standardisation even at a local level, while in others, progress would be needed on a regional, or international, basis.

Hindrances to International Standardization of Islamic Finance

1) Different interpretation of the Quran
2) Different application of similar contract
3) Different practices allowed that is the opening of “Islamic windows” within conventional banks which “acceptable in many countries outside Middle Eastern countries but not acceptable in some Middle Eastern Countries”.
4) Different spelling of the Arabic terms used in Islamic financing between two functions such as Shia and Sunni with both groups interpreting aspects of Quran different and having different spellings of the Arabic terms.