

Frequently Asked Questions – Islamic Finance General

Question

What is the difference between Islamic Banking and Islamic Finance?

To understand this, one needs to keep in mind the difference between the term 'Finance' and 'Banking'. Islamic Finance is a broader term. It includes Islamic Banking, Islamic Insurance known as Takaful, Islamic Asset Management (Islamic Mutual Funds etc). Islamic banking is part of Islamic Finance, but, both are used interchangeably sometimes as Islamic Banking represents still the significant portion of Islamic Finance as it has more institutions, more asset base, more client base and is practiced more commonly in the world than some the other class of institutions in Islamic Finance which are in development stage.

Question

What is Islamic Finance or how would you define it?

Islamic Finance is a broader term. It includes Islamic Banking, Islamic Insurance known as Takaful, Islamic Asset Management (Islamic Mutual Funds etc). It is a set of financial institutions and financial instruments which comply with Islamic principles and their compliance is vetted by Islamic scholars. It does not include the concept of interest. But, defining it only as interest free finance would not be appropriate. It is due to the fact that Islamic Finance strives to comply with all Islamic injunctions including prohibition of Riba and other economic injunctions like avoiding Gharar, Maysir, Qimar etc.

Question

What is Shari'ah?

Shari'ah literally means "way" or "path". Technically, it refers to the law of Islam. It is a set of injunctions derived from two primary Sources of Islamic law, namely Qur'an and Sunnah (the sayings and example set by the Prophet Muhammad (peace be upon Him)).

Question

What are the main features of Islamic Finance?

Islamic Finance is a set of financial institutions and instruments which comply with certain Islamic principles and avoid certain Islamic prohibitions. Its main features include but are not limited to:

- Prohibition of Riba.
- Prohibition of Gharar (excessive uncertainty) in sale transactions.
- Prohibition of Maysir and Qimar
- Prohibition of sale of Debt
- Prohibition of certain sale transactions like buy back, short selling etc.

Over the years, Islamic scholars and Shari'ah Advisors have formulated specific principles for each economic scenario, financial instrument and financial institutions and Islamic Finance now has a separate and comprehensive governing framework.

Question

How Islamic Banking is different from Conventional Banking?

Islamic Banking is not based on the concept of lending money for interest. In Islamic Banking, money is not lent. It provides finance to the clients who have a need for asset. Islamic Banking does not consider money as commodity since it does not have any intrinsic value of its own.

It provides finance to clients for the purchase of assets using either leased based modes of finance like (Ijarah, Diminishing Musharakah etc) or trade based modes of finance like (Murabaha, Salam, Istisna etc). Since profit on trade and rent on the usufruct of an asset is permissible in Islam, hence, Islamic Banking has legitimate source of income.

On the deposits side, Islamic banks do not give stipulated interest to the clients. When they take deposits from general public except in Current Account, the underlying contract is not that of a Qard (loan). Rather, the depositors invest money and share in actual profits based pre-agreed profit sharing ratio. Hence, element interest is not present in Islamic banking in either deposit mobilization or while providing finance to different clients.

Question

What is Riba and what constitutes Riba?

Riba is a technical term in Islamic Shari'ah. It refers to 'Anything paid/charged over and above the principal amount on a loan'. It is an undisputed and agreed upon definition of Riba and is backed up by the consensus of all Islamic scholars and schools of jurisprudence.

It is used in this specific sense in Islamic Shari'ah and does not include all forms of exploitation. Most definitely, Islam prohibits all forms of exploitation; however, Riba is a technical term and refers to the particular type of exploitation in a loan transaction when something over and above the principal is taken or is charged.

Question

Why Interest is prohibited in Islam?

Interest is prohibited in all monotheist religions (See Exodus 22:25, Leviticus 25:35-36, Deuteronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezekiel 18:8,13,17 & 22:12).

Allah in Quran said:

“Do not do wrong nor be wronged” (Al-Baqarah: 279).

It means that interest either results in injustice to the borrower or sometimes it results in injustice to the lender when real interest rates are negative (inflation rate during the period of loan being higher than the interest rate received on loan). Lender can sometimes also be subject to exploitation by the rich debtor. Interest is also prohibited against its negative effects on enterprise.

In investment for trade (which Islam allows), the investment goes through the entire process of a commercial activity that involves risk taking at each stage and any compensation on investment is strictly dependent upon the outcome of the commercial activity. The profit for the businessman strictly

depends upon the actual profit realized after taking market risk including price risk. It does not depend upon time.

Time value of money is the basis of interest. Time value of money is the problem for the investor to avoid keeping his money idle and to avoid forgoing the use of money that may bring positive value to his investment. However, it does not mean that the investor can demand an arbitrary increase (or is given as the case may be) as the cost of using money without taking the market and price risk.

Question

Is Islamic Finance only for Muslims?

Islamic Finance industry is a nascent but growing industry. Islamic financial industry beyond banking has achieved financial deepening in Mutual Funds industry, Investment Banking, Public Finance and insurance. On the geographical level too, Islamic banking has grown from Middle East to Europe and now is well positioned in South Asian markets as well.

Assets of the global Islamic finance industry are estimated to grow to around \$1.6 trillion by 2012 (Source: Reuters). Some reports suggest that assets held by Islamic financial institutions may rise five-fold to more than \$5 trillion (Source: Moody's Investor Service).

Islamic Banking is growing rapidly throughout the world. Islamic Banking has been introduced in more than 60 countries of the world. Global financial players like Citibank, ABN AMRO, American Express Bank, HSBC etc are also participating in Islamic Banking and Financial Industry.

Islamic banking products are competitive and are financial products which comply with Islamic principles than being religious products. Since interest is prohibited in all monotheist religions. Hence, more than two-thirds of the world has the need for Interest free finance. Furthermore, since these products are competitive, they can appeal to non-religious investors too.

Question

What are the different challenges faced by Islamic Finance industry?

Islamic finance industry faces a lot of challenges. First, the size of the Islamic financial institutions is not large and they are not able to generate economies of scale like big financial institutions in the conventional category can do.

They also have to improve their operational efficiency as they have to follow dual regulatory framework to ensure compliance with general framework and to ensure Shari'ah compliance.

They also have the challenge of bringing standardization, managing innovation smoothly and through consensus. Besides these, the biggest challenge for them is to develop human resource in line with their robust growth. Dearth of Shari'ah Advisors is also a big challenge for them and more institutions are needed for training experts for Shari'ah laws and those who are well conversant with modern day financial system.

Question

When did Islamic Finance originate?

In Egypt, first Islamic savings bank was established based on the principle of profit-sharing at Mitt Ghamr in 1963. The Islamic financial system in Malaysia was first introduced in 1963. It started from a modest beginning with the establishment of the Malaysian Pilgrims Fund Board (Tabung Haji), to the setting up of the country's first Islamic bank, Bank Islam Malaysia Berhad (BIMB), which commenced business on 1 July, 1983.

In 1975, the Islamic Development Bank was established to provide financing to projects in the member countries. Dubai Islamic Bank was the first modern Islamic commercial bank founded in 1975. Indonesia's first Islamic bank was Bank Muamalat, which was established in 1991. In Bahrain, first Islamic commercial bank was established in 1978. In Pakistan, Meezan Bank was the first Islamic commercial bank established in 2002.

Question

What are the main services provided by an Islamic bank that a conventional bank does not provide?

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Question

What is a Shari'ah Board?

Shari'ah board comprises Islamic scholars who are experts in Islamic jurisprudence. Shari'ah board has the task of ensuring compliance to Islamic principles in products offered by Islamic Financial Institutions (IFIs). All the products offered by IFIs have to be vetted by the Shari'ah board. Their verdict and judgment is binding on the management and their presence and affiliation with IFIs provide a level of comfort to the customers of IFIs.

Question

What are the laws of Islamic Finance?

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In Pakistan, State Bank of Pakistan has issues separate guidelines for Islamic banks pertaining to Opening an Islamic Window, Risk Management, Appointment of Shariah Advisors etc. Accounting & Auditing Standards for Islamic Financial Institutions (AAOIFI) standards are also a guiding light for IFIs. In specific and particular circumstances, the appointed Shari'ah Advisor for IFIs gives Islamic verdict on particular matters which is binding on the management.

Question

How Important is Islamic Finance?

Islamic Finance is very important for those especially who want to avoid interest. It provides them an alternate system which is as competitive and comprehensive in product offerings as the conventional system. It allows people and institutions who are looking to avoid interest to still have access to financial services which do not have an element of interest.

Catering to these customers with competitive product offerings, positive impact can be expected on the economy and financial system. Furthermore, since the last few decades have shown the fragility present in interest based

financial system, the Islamic financial system, in this respect, can provide a much more stable system to the world economy.