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# Islamic Finance: Ethics, Concepts, Practice (a summary)

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Islamic economic thought and finance are rooted in Islamic ethics, but their ideals and means are not exclusive to Islam. The principles of Islamic finance emphasize market-based risk sharing of financing that promotes asset and enterprise, deploys finance in the service of the real economy, and facilitates redistribution of wealth and opportunity. Modern Islamic financial practices, however, promote legal forms over economic substance, creating an expectations gap between theory and practice. In the wake of the global financial crisis of 2007–2008, the ideas underlying Islamic finance appeal to people who are concerned with the broad impact of finance on society.

## Many Debates about Islamic Finance

Widely regarded as one of the fastest-growing segments of global finance, Islamic finance is the subject of many debates. Should religion have anything to do with finance? Can guidance about economics and finance be derived from Islam? What exactly is meant by prohibition of *riba* in Islam? Is equity financing superior to debt financing for long-term economic prosperity? Is the Islamic financial sector “Islamic” only in form, not in substance? Can such a thing as an Islamic commercial bank operate within the prevalent monetary and banking system? Will following the legal minimum of Islamic commercial jurisprudence by commercial financial institutions lead to fulfillment of the higher objectives of Islam?

These questions are but a sample of the debates regarding Islamic finance.

Such debates in this field give rise to many opinions, but it is a matter of fact rather than opinion that Islamic finance is the most prominent faith-based finance in the world today. One way to describe it is “finance that is consistent with Islamic teachings.” Specifically, Islamic finance must avoid “sin” (i.e., prohibited) businesses; it must also abide by the Islamic prohibitions of *riba* and excessive *gharar*, which are generally understood to include, respectively, lending money at interest and sale of risk.<sup>1</sup> Consider a simple

<sup>1</sup>We are of the view that translating the Arabic terms *riba* and *gharar* tends to cause more confusion than clarity. Therefore, throughout the literature review, we do not use any English translation of these terms.

application: Islamic finance is not to be used to finance a brewery because the underlying activity—consumption of alcohol—is prohibited by Islam. Similarly, the money cannot be used for lending money at interest (as is the case in a conventional bond) or sale of risk (as in conventional derivatives and proprietary insurance) because of the prohibitions of *riba* and excessive *gharar*. An idea strongly associated with Islamic finance is that the financiers and those being financed need to assume the risk associated with business outcomes or ownership of an asset. Where risk is to be managed through insurance, it should be managed through a mutual risk-sharing arrangement. The prohibitions, therefore, promote risk sharing and applying assets and enterprise in the real economy, facilitating redistribution of wealth and opportunity and social solidarity.

## About the Literature Review

Using literature published since the year 2000, this review introduces the subject of Islamic finance and outlines the context to the literature; discusses Islamic economic thought and highlights its pertinence for Islamic finance; explains the major elements of Islamic law and prohibitions concerning Islamic finance; addresses the use of “nominate” contracts and promises (or legally binding unilateral undertakings) in structuring Islamic finance products; touches on regulatory issues; spells out governance and social responsibility; discusses the political economy in which Islamic finance operates; elaborates on the “form versus substance” debate; and summarizes the findings of some of the empirical studies while offering concluding thoughts.

We touch on a few of these elements in this summary.

## Origins

The ideas and practice of Islamic finance are not necessarily exclusive to Islam but have a wider appeal. Many non-Muslims participate in Islamic finance in various capacities, including as entrepreneurs, business partners, professionals, investors, customers, and thought leaders.

Modern Islamic finance practices—unlike Islam, which dates back to the 7th century—are a 20th-century phenomenon. Islamic finance includes banking, capital markets, and insurance in various countries of the world, but in terms of its assets, the industry largely consists of commercial banking in countries with Muslim-majority populations. And Islamic finance is growing rapidly. Industry reports estimate the total assets in Islamic finance at about \$1.5 trillion as of 2013 and observe a double-digit compound growth rate in recent years, with similar growth forecast for the foreseeable future.

## Common Misconceptions

A host of misconceptions are associated with Islamic finance. For example, Muslims and Islamic finance are monoliths that conform to generalizations; modern Islamic finance is a relatively old and mature industry; most Muslims understand the theory and practice of Islamic finance and follow it in their financial lives; Islamic finance enjoys active government support in most Muslim-majority countries; the assets of Islamic finance tend to be greater than those of conventional finance in most Muslim-majority countries; Shari'a is the governing law in all countries with a Muslim majority, and Islamic finance transactions are governed only by Shari'a; Islamic finance is not open to non-Muslims; Islamic finance is mainly about charitable rather than commercial activities; Islamic finance involves illegal activities, such as money laundering and even the financing of terrorism; prohibited *riba* is the same as interest; Islamic finance is recession proof and immune from unethical practices; and the Islamic finance industry is widely believed to be Islamic in form and in substance.

## Islamic Economic Thought

Islamic economic thought (or Islamic economics) is the cornerstone for the theory and practice of Islamic finance. The Islamic worldview places moral checks on the economic behavior of believers, but ideas associated with a market economy and capitalism are not necessarily inconsistent with Islamic economic thought. Islamic economics places special emphasis on social justice and espouses a strong preference for risk sharing, profit sharing, and equity-like modes of financing. Debt is viewed with suspicion.

The salient instruments for redistribution are profit-sharing contracts, a social welfare tax (*zakah*), charitable giving (*sadaqa*), charitable endowment (*waqf*), interest-free loans (*qard hasan*), and inheritance.

Islamic economic thought espouses ideals that are not always followed in practice. Economic decision makers in Muslim-majority countries, for example, have shown little interest in translating the underlying vision of Islamic finance into reality.

## Islamic Finance in Practice

Islamic financial transactions in banking, capital markets, and insurance are structured through nominate contracts and promises as found in Islamic commercial jurisprudence.

**Commercial Banking.** On the liability side, Islamic commercial banks offer various types of accounts. Some types are safekeeping accounts without any prospect of return on the deposit. The bank, however, may offer return in

the form of a discretionary gift. There are also investment accounts, which may be restricted or unrestricted in their scope. These investment accounts tend to be based on a contract similar to investment management.

On the asset side, Islamic commercial banks use these nominate contracts (alone or combined with other types of contracts) to offer various other financing arrangements. The most common contract in Islamic financial practice is a trust sale, also referred to as banking *murabaha*. In this arrangement, the financier buys a good and sells it to the customer on installment credit, in which arrangement the credit price is more than the spot price. By owning the asset, the financier is seen as assuming the risk associated with asset ownership. From the perspective of Islamic commercial jurisprudence, however, clear evidence must be available that legal title and possession of the asset (whether actual or constructive) are actually transferred to the financier before the good is sold to the customer.

**Capital Markets.** In discussing Islamic finance in the capital markets, we cover equity funds and *sukuk*.

■ *Equity funds.* The majority of Islamic funds are long-only equity funds. Generally, Islamic equity funds follow exclusionary screening to avoid companies whose primary business is in conflict with Islamic jurisprudence. The greatest impact of exclusionary screening is usually the removal for consideration of the conventional financial and insurance sectors, which are sometimes the largest sectors in stock exchanges.

After the initial screening based on a company's primary business, further exclusionary screens are applied to avoid businesses with an unacceptably high level of impermissible income (usually 5%). Businesses with high interest-bearing debt (usually more than a third of market capitalization or total assets) are also excluded. Dividend income attributable to impermissible income is donated to charity, although the same is not attempted for capital gains, which remains a subject of debate. The screening process is generally negative, although positive alignment is also deployed in some cases (e.g., investing in an Islamic sustainability index).

■ *Sukuk.* Islamic investment certificates (*sukuk*) should represent ownership in real assets, whereas conventional bonds are about ownership of financial debt. *Sukuk* can be structured in a variety of ways, even when using the same underlying nominate contract. A common structure underlying *sukuk* is a lease (*ijara*). The originator sells an asset to a special-purpose vehicle (SPV), which is the *sukuk* issuer, and receives the initial cash flow. The SPV leases the asset back to the originator, which pays rentals to the SPV. Upon expiration of the agreed term, the originator, calling on the purchase and sale undertakings previously signed, buys back the asset at a fixed price. The rent of the asset may comprise the principal, a rate of return, and any charges incurred for maintaining the asset. The originator thus acts as a seller, lessee, obligor, and servicing agent.

**Islamic Insurance (*Takaful*).** Instead of selling risk, which goes against the prohibition of excessive *gharar*, in *takaful* (solidarity, mutual obligation), risk is to be shared through mutuality. The majority of *takaful* providers are set up as hybrids of mutual and proprietary insurance, in which a for-profit shareholder-owned company operates the mutual *takaful* pool. Insurance coverage is provided by the *takaful* participants to each other through the participants' *takaful* fund, and the *takaful* operator manages the underwriting and investment on behalf of the *takaful* participants. In general, agency (*wakala*) contracts and investment management (*mudaraba*) contracts are used between the participants and the operator for, respectively, underwriting and investment management. The *takaful* operator earns a fee on the underwriting contributions and shares part of the profits from investments. Constraints apply to the investments of *takaful* funds, which are usually made in equities, *sukuk*, real estate, and profit-sharing investment accounts with Islamic banks.

## Form vs. Substance Debate

A frequent criticism of the contemporary practice of Islamic finance is that it is “Islamic” in legal form but conventional in economic substance. The form versus substance debate signifies the gap between the principles of Islamic finance and its practice. Although conventional interest-bearing monetary loans are described as un-Islamic, they are mimicked in Islamic finance, eliminating any substantive difference between the two—especially in commercial banking, which is the largest segment of the Islamic finance industry. Because critics find Islamic and conventional finance unusually similar where they were expected to be different as a result of Islamic prohibitions, they question the Islamic credentials and socioeconomic value addition of Islamic finance.

## Empirical Studies and Concluding Thoughts

Comparative empirical studies of the performance of Islamic finance are complicated by the similarities in the underlying substances of conventional and Islamic finance, especially in Islamic commercial banking. Those who consider Islamic finance a success tend to focus on growth and profitability; those who consider it a failure typically question its Islamic authenticity and social and economic value.

Islamic finance also generally operates within a political economy that is predicated on preserving rather than changing the status quo. Where a government has actively supported Islamic finance, the system retains an uncomfortable similarity to conventional finance.

Some have questioned the direction of Islamic finance by asking why it is concerned with morally regulating the operations of individual business people

rather than promoting economic growth at the macro level and distributing resources in accordance with Islamic principles of social justice.

Nevertheless, in the wake of the global financial crisis of 2007–2008, the ideas underpinning Islamic finance might appeal to those who aspire to a relatively restrained financial system and are concerned about the broad impact of finance on society.

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The complete book can be found at  
<http://www.cfapubs.org/toc/rflr/2014/9/3>.



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