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DEVELOPMENTS IN ISLAMIC FINANCE

Challenges and Initiatives

Syed Aun R. Rizvi
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Palgrave CIBFR Studies in Islamic Finance

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Palgrave CIBFR Studies in Islamic Finance
ISBN 978-3-319-59341-8 ISBN 978-3-319-59342-5 (eBook)
DOI 10.1007/978-3-319-59342-5

Library of Congress Control Number: 2017944223

Cover illustration: Pattern adapted from an Indian cotton print produced in the 19th century

Printed on acid-free paper

This Palgrave Macmillan imprint is published by Springer Nature
The registered company is Springer International Publishing AG
The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

Preface

This book has been born out of the need to further the development in Islamic finance. The critique of Islamic finance as limited to a segment of society following a specific faith has developed over the years. With the growth in the financial sector globally, Islamic finance has shown tremendous potential in terms of both growth and resilience.

This book brings to forth new ideas and innovative solutions within the paradigm of Islamic finance which the world faces today. The first chapter apprises the readers of the status of Islamic finance, bringing in facts and figures and highlighting the pitfalls of the recent growth in Islamic finance.

The fastest-growing sector of the Islamic finance is the fixed-income instrument of Sukuk. With our world facing a challenge of water deprivation, and concerns being raised over what we would leave behind in terms of the water supply for our future generations to come, this book introduces an innovative Sukuk instrument which addresses some of the concerns in terms of financing of water-based projects. With taking Malaysia as a case study, second chapter argues for the benefits of reducing non-revenue water (NRW) in terms of value and solving the issue through structuring green sukuk to finance NRW work. With the focus and development of Sukuk structures and innovative instruments, the concern of financial mismanagement and defaults has become a reality. This book also highlights these challenges by taking the case of Villamar Sukuk in trying to decode the nature and causes of the difficulties encountered in quick settlement of defaulted sukuk.

Sukuks are not the only sector raising interest for innovation and further inquiry. A thought-provoking proposal is put forward in this book which introduces a concept of saving-based Takaful products that can help people in Pakistan in planning the future for their children's education. With the global focus on providing quality education to our kids, this case study provides some empirical findings which aim to further encourage thought and development in the educational sector.

While instrument-specific debates engage readers and practitioners across the breadth of this book, taking a break from the tradition, and keeping in mind the global nature of the world we live in, a case plan on introducing Islamic finance to unchartered territories is presented by the author/s through building a case for Islamic finance beyond its faith-based association only.

While no discussion is complete without a macroeconomic aspect, this book concludes with an insightful article on explaining the role of Islamic finance in a multipolar world and the emergence of Black Swan events. A strong argument is built on the role of Islamic finance by arguing that continuation of debt-based financing regime will not necessarily allow the benefits of emerging multipolarity to accrue to the world economy. The new system can be more effective with a new regime of financing. Indications are that almost all emerging countries in Asia are actively considering risk sharing via Islamic finance as a possible alternative.

Lahore, Pakistan Syed Aun R. Rizvi

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Islamic Finance, in the Age of Black Swans and Complexities, for a Multipolar World

Islamic Finance—Local and Global Status

Irum Saba

Abstract This article apprises the readers on the current status of Islamic finance across the world. Islamic finance though nascent has grown manifolds in the recent years and has spread across many different jurisdictions. With Pakistan as a Muslim-majority nation, it has been at forefront of the efforts and growth of Islamic finance. The article provides some insights into way forward for the industry.

Keywords Islamic banking · Islamic finance · Shariah · Islamic windows · Islamic Financial Services Board (IFSB)

1 Introduction

One of the biggest challenges faced by the world is to have a balanced and successful economic system without any financial crisis. Muslims of the twentieth century worldwide have been trying to establish

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S.A.R. Rizvi and I. Saba (eds.), *Developments in Islamic Finance*, Palgrave CIBFR Studies in Islamic Finance, DOI 10.1007/978-3-319-59342-5_1

a financial system and financial institutions in accordance with the principles of Shariah, or Islamic law. In an environment where usually the entire financial system, from the sovereign government to financial markets and small- and large-scale financial institutions (FIs), is inherently based on interest, this is indeed a formidable task.

The term "Islamic finance" is often heard of as an oxymoron. The listener thinks of Islam as a philosophy that guides one to prepare for the life of the hereafter and implies purification from greed and perhaps even a general disinterest in the pursuit of wealth, prosperity, or economic gain. Finance and banking, on the other hand, is to a great extent about maximizing shareholder's wealth, depositors' savings, investors' returns, corporate culture, and surviving in the extremely competitive market. Then, how can a system or organization pertaining to financial industry be Islamic? One way to analyze this question is to think about "Islamic" finance as simply "Islamic law-compliant" finance—a system which tries to embody the economic and social teachings of Islam.

It is sometimes perceived that a religious system of law traditionally focuses only on matters pertaining to worship. It may even be conventional, old-fashioned, limited in its use, or at least difficult in widely applying it in the complex and dynamic matters of an economy. So how can it provide precise, practicable rulings and principles for financial systems? The fact is that Islamic Law, or Shariah, prerogatives to be a "complete code of life," and though there are elements of flexibility, custom, *Masalaha al Mursalaha* (public benefit), and valid differences of opinion in its legal system, it claims to be an applicable system for all societies and all times to come. Islamic Law, or the Shariah (meaning a "path" to righteousness), can be subdivided into two broad categories: Fiqh-ul-Ibaadat (laws pertaining to worship matters) and Fiqh-ul-Muamalat (laws pertaining to human dealings). The latter is of special relevance to Islamic finance, and it includes Islamic law for valid contracts, valid sales, halal (permissible), Makrooh (disliked) and haram (impermissible) activities or sources of income, laws relating to inheritance, marriage and divorce, relationships, transactions, governments and economics, wealth management, modesty and interpersonal interactions, etc. While this is a very broad category, Fiqh-ul-Ibaadat, on the other hand, deals almost exclusively with matters of worship and a Muslim's personal purification and relationship with his/her Creator. It includes rules for Salah, fasting, pilgrimage (Hajj and Umrah), prayers and invocations, and purification from diseases of the heart such as greed, jealousy, pride, anger, and lust Interestingly, the sources of these two categories of Islamic law and their methodologies are the same. There are, of course, some important matters that fall in an overlap—Zakat, for instance, is a mandatory charity on all able Muslims and one of the five main acts of worship, covered in Fiqh-ul-Ibadat, but its rules are much relevant to the economy and Islamic financial systems as well.

Islamic banking is simply a subset of Islamic finance: an industry that includes banks, central banks, development banks, financial markets, Takaful (insurance) companies, asset management companies, brokerage houses, research and educational centers, and Islamic capital markets. The main objective of Islamic finance is to enable a financial system that is stable; fulfills the *halal* (permissible) economic needs of the consumers, corporations, and government in the economy; supports the real economy; and leads to an equitable distribution and circulation of wealth in the society, while avoiding impermissible activities, trades, and transactions. The main impermissible transaction elements according to the Islamic Law (Shariah) include Riba (interest), Maisir (gambling), Gharar (excessive uncertainty), and Uqood-ul-Fasida (or invalid transactions, such as forward sale, short selling, sale of debt, and sale and buy back). A financial institution or a firm that is compliant with Islamic law is also forbidden from dealing in any *Haram* (impressible in Shariah) activities or industries, such as alcohol, pork, tobacco, and Haram entertainment. Hence, an Islamic financial institution (IFI), or a "Shariah-compliant" bank, is simply an institute that meets the economic or financial demands of its consumers in a way that does not go against the commands of the Shariah.

An Islamic economic system, at least theoretically, strives to achieve some greater principal objectives of the Islamic Law with its activities, modes, rules, and prohibitions. According to the reputed historic Islamic scholar, Imam Al Ghazali, the ultimate objectives of Islamic Law, or the *Maqasid al Shariah* (the main Objectives of the Islamic Law), can be briefly described as:

> The very objective of the Shariah is to promote the well-being of the people, which lies in safeguarding their faith (din), their lives (nafs), their intellect (aql), their posterity (nasl), and their wealth (mal). Whatever ensures the safeguarding of these five serves the public interest and is desirable, and whatever hurts them is against public interest and its removal is desirable.[1]

He lists five elements that Islam attempts to protect: (1) Religion, (2) Lives, (3) Intellect, (4) Lineage, and (5) Property, wealth, or economic prosperity. Shariah is based on the four main sources of Islamic Law: the *Quran*, the *Sunnah* (which includes the sayings, practices, and tacit approvals of the Prophet Muhammad (Peace be upon him)), *Ijma* (consensus of the Islamic jurists/scholars on a matter), and *Qiyas* (analogical deductions, or juristic efforts/Ijtihad of qualified Islamic scholars on a legal matter not explicitly answered in Quran, Sunnah, or Ijma). As Islam is a religion that claims to be a complete code of life, the Shariah offers its followers commands, prohibitions, and guidelines on beliefs (Aqaa'id, e.g., in One God, revealed in books, prophets, angels, Life after death, etc.), Worship matters (Ibaadat, such as fasting, prayers, Zakat, pilgrimage), and human-to-human dealings (or Muamalat). The latter includes matters relating to transactions and economics and finance.

Though Islamic financial institutions are forbidden legally from undertaking any transactions that involve Riba or any of the other Shariah-prohibited elements, nevertheless, they can use certain modes of financing that are prescribed by Islam. These can be summarized into profit-sharing modes, leasing modes, and structures based on sale of assets (usually for a profit). Shariah compliant modes used in Islamic finance worldwide help the financial institutions in generating income, investing, or managing their liquidity including the following:

One of the most common modes of financing used by Islamic financial institutions (IFIs) is *Murabaha*. This is a kind of sale where the IFI sells a customer (firm or individual) a specific kind of asset they require (such as a vehicle, machinery, and commodity), that is in its possession. As this is a sale and not an interest-based loan, the price of the asset is the sum of the original price (which is disclosed to the client) and an agreed profit margin. Hence, Murabaha is also called "mark-up sale."