

Understanding Islamic Finance

Muhammad Ayub



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*In the Name of Allah,
the Most Merciful, the Most Beneficent
For my youngest daughter, Wardah*

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Foreword

The last decade has seen an unprecedented growth not only in the practice of Islamic banking and finance but also in the literature on Islamic finance. This book, however, is not merely another addition to the available literature. It has a marked distinction. It not only places theory and practice in one place along with Sharīah (Islamic law) underpinnings, but also provides an objective assessment of conformation of the practice to the theory. A good coverage of recent innovation in Islamic financial products is also a distinguishing feature of this book.

Islamic finance is a subject that has now been recognized as a distinct academic discipline to be included in the curricula of economics, business, finance and management faculties of institutions of higher learning. There are several universities and institutions, both in Muslim and other countries, that are teaching courses on Islamic banking and finance. These teaching programmes, however, have been seriously constrained by the non-availability of a standard textbook to be followed. I can say with confidence that this book carries the status of a textbook to be prescribed in the senior levels of undergraduate programmes as well as in graduate programmes in the relevant faculties.

Islamic finance is still a new subject. There is great interest in conducting research on different aspects of its theory and practice in the contemporary set-up. Students of economics and finance keenly look for topics of research in this field. The analytical approach adopted in this book is conducive to bringing to light potential areas of research. Thus, research students in the area of Islamic finance should find this book a must read.

The author of the book has a long experience of research in the State Bank of Pakistan (the central bank of the country), which has played, during the last decade, a significant role in promoting Islamic finance in the country. By virtue of his position in the research department of the State Bank of Pakistan, he has a very valuable insight into the operations of Islamic banks as well as their feasibility to survive in competition with the conventional banks in the country. His approach in presenting the material in this book is very pragmatic.

The book, thus, is a useful guide to all those who would like to establish an Islamic bank or would like to work in Islamic financial institutions.

I congratulate the author as well as the publisher in bringing out this useful book.

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Preface

Islamic scholars have been critically examining the modus operandi of modern commercial banks ever since their establishment in the Muslim world in the last decade of the nineteenth century. As time passed, the consensus emerged among the scholars that the system was against the principles of Sharīah, mainly because of paying/charging returns on loans and debts. Keeping in mind that direct or indirect intermediation between resource surplus and resource deficit units was necessary to fulfil the growing needs of human societies and for the development of business and industry, Islamic scholars and economists started offering conceptual models of banking and finance as a substitute for the interest-based financial system by the middle of the twentieth century.

Institutions offering Islamic financial services started emerging in the 1960s in isolation, but the movement of Islamic banking and finance gained real momentum with the establishment of Dubai Islamic Bank and the Jeddah-based Islamic Development Bank in 1975. In the evolutionary process, the initial theoretical model of two-tier Mudarabah developed into a versatile model enabling the Islamic financial institutions (IFIs) to conduct trading and leasing business to earn profit and pass on a part of the same to the savers/investors. To complete the cycle of Islamic finance, institutions offering Takaful services started emerging in 1979 as a substitute for the modern insurance system.

While the increasing involvement of the Sharīah scholars, creative work by research institutions like the IRTI (IDB) and the issuance of Sharīah Standards by the AAOIFI (Bahrain) provided a critically needed base to the emerging financial discipline, participation of the world's top banking institutions like HSBC, BNP Paribas and Citigroup in the 1990s provided a driving force to transform it from a niche discipline to a global industry. The establishment of the Islamic Financial Services Board (IFSB) in 2002, as a standard-setting institution, also paved the way for making Islamic finance a globally acceptable proposition. It provided impetus for the promotion and standardization of financial operations of Islamic financial institutions (IFIs), involving consultations among the relevant regulating authorities and the international financial institutions. The emergence of Sukuk as investment and liquidity management instruments in the last six years not only tended to complete the investment cycle in the emerging financial structure, but also provided a powerful driving force for its development, with huge potential ahead.

The above progress reveals that the Islamic finance industry has crossed the significant milestone of having increasingly wider acceptance at a global level. The amazing development so far, the present state of affairs and the challenges ahead give rise to some crucial considerations for the experts, policymakers and practitioners in Islamic finance. First, the rapid growth of the industry over the last decade has enhanced the demand for committed, devoted and professionally trained personnel for Islamic banking operations. Second, the industry, as it has emerged, is facing a credibility challenge on the grounds of lack of awareness among the public and also due to the general perception that Islamic banks' present framework, with a reliance on debt-creating modes like Murabaha, might not be helpful in realizing the objectives that its pioneers had visualized for transforming the interest-based financial system to a system compatible with the tenets of the Sharī'ah.

Bankers, the business community, industrialists, Sharī'ah scholars and the general public need to know what Islamic finance is, what its features are and how it works. In particular, students of business and finance, the product developers for the emerging industry and the personnel involved in operations need to have proper knowledge of the principles of Islamic finance, the essential requirements of different Islamic modes of financing and how they can be applied to various operations and services of banks and financial institutions. Accordingly, the availability of any comprehensive book, covering both theory and practical aspects of Islamic finance, is regarded a prerequisite for promoting Islamic banking and finance.

In the above scenario, I was asked by John Wiley & Sons to produce a write-up that could serve as a textbook for students, bankers and all others who want to understand the philosophy, modes, instruments and operations of Islamic banking and financial institutions. I accepted the challenge and worked on the outline, covering Islamic economics as the basis of Islamic finance, principles of Islamic finance, the main features of Islamic commercial law, modes, products and procedures to be adopted by Islamic financial institutions and the role Islamic finance can play in the development of the financial system and economies. The book contains discussion on the basic modes, followed by the procedures that IFIs are using or may adopt to fund a variety of clients, ensuring Sharī'ah compliance. Practical and operational aspects covering deposit and fund management by Islamic banks involving financing of various sectors of the economy, risk management, accounting treatment and the working of Islamic financial markets and instruments have been discussed in suitable detail.

The external reviewer of Wiley, while giving his expert opinion on the original manuscript, suggested adding a chapter on appraisal of common criticism of Islamic banking and finance. Although such discussions were there in scattered places in the book, covering all criticism and misconceptions about the principles and operations of Islamic banks in one chapter in the final manuscript will hopefully help readers to remove confusion, besides adding value to the book.

In preparing the book, I have benefited from the traditional books of Islamic jurisprudence, the literature available so far on Islamic banking and finance, resolutions of the Islamic Fiqh Council of the OIC – the highest body representing Sharī'ah scholars of all major Islamic countries, the Sharī'ah Standards developed by the AAOIFI and rulings of the Sharī'ah boards of some Islamic banks. As such, it reflects the consensus/mainstream viewpoint relating to principles of the Islamic financial system, modes of financing and their essential Sharī'ah requirements that are recognized on a wider scale and are the bases for Islamic banking practices in the Middle East and other parts of the world. In places, the minority view in respect of some products has also been included to give a measure of dissent.

