Understanding	Islamic	Finance	

## Muhammad Ayub



John Wiley & Sons, Ltd

Understanding Islamia Finance	
Understanding Islamic Finance	

# For other titles in the Wiley Finance Series please see www.wiley.com/finance

Understanding	Islamic	Finance	

## Muhammad Ayub



John Wiley & Sons, Ltd

Copyright © 2007

John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex PO19 8SO, England

Telephone (+44) 1243 779777

Email (for orders and customer service enquiries): cs-books@wiley.co.uk Visit our Home Page on www.wiley.com

All Rights Reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning or otherwise, except under the terms of the Copyright, Designs and Patents Act 1988 or under the terms of a licence issued by the Copyright Licensing Agency Ltd, 90 Tottenham Court Road, London W1T 4LP, UK, without the permission in writing of the Publisher. Requests to the Publisher should be addressed to the Permissions Department, John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex PO19 8SQ, England, or emailed to permreq@wiley.co.uk, or faxed to (+44) 1243 770620.

Designations used by companies to distinguish their products are often claimed as trademarks. All brand names and product names used in this book are trade names, service marks, trademarks or registered trademarks of their respective owners. The Publisher is not associated with any product or vendor mentioned in this book.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold on the understanding that the Publisher is not engaged in rendering professional services. If professional advice or other expert assistance is required, the services of a competent professional should be sought.

The views expressed in this book by the author are those of the author and are not necessarily those of the publisher. The publisher accepts no responsibility for such views.

#### Other Wiley Editorial Offices

John Wiley & Sons Inc., 111 River Street, Hoboken, NJ 07030, USA Jossey-Bass, 989 Market Street, San Francisco, CA 94103-1741, USA Wiley-VCH Verlag GmbH, Boschstr. 12, D-69469 Weinheim, Germany John Wiley & Sons Australia Ltd, 42 McDougall Street, Milton, Queensland 4064, Australia John Wiley & Sons (Asia) Pte Ltd, 2 Clementi Loop #02-01, Jin Xing Distripark, Singapore 129809 John Wiley & Sons Canada Ltd, 6045 Freemont Blvd, Mississauga, ONT, L5R 4J3, Canada

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books.

Anniversary Logo Design: Richard J. Pacifico

#### Library of Congress Cataloging in Publication Data

Ayub, Muhammad, 1951-

Understanding Islamic finance/Muhammad Ayub.

p. cm. — (Wiley finance series)

Includes bibliographical references and index.

ISBN 978-0-470-03069-1 (cloth: alk. paper)

Finance—Islamic countries.
 Finance—Religious aspects—Islam.
 Economics—Religious aspects—Islam.
 Title.

HG3368.A6A98 2007

332.0917'67—dc22

2007035537

#### British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

ISBN 978-0-470-03069-1 (HB)

Typeset in 10/12pt Times by Integra Software Services Pvt. Ltd, Pondicherry, India Printed and bound in Great Britain by Antony Rowe Ltd, Chippenham, Wiltshire This book is printed on acid-free paper responsibly manufactured from sustainable forestry in which at least two trees are planted for each one used for paper production.

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

## Contents \_\_\_\_

List of Boxes and Figures		xvii	
Forewor	d	xix	
Preface		xxi	
Acknow	ledgements	XXV	
PART I	FUNDAMENTALS	1	
1 Intr	roduction	3	
1.1	Economic Scenario in the Neoclassical Framework	3	
1.2	Conventional Debt: A Recipe for Exploitation	4	
1.3	Growth per se May not Lead to Socio-economic Justice	6	
1.4	Social Welfare Activities of the States	8	
1.5	The Main Culprit	8	
1.6	The Need of the Hour	9	
1.7	Economics and Religion	10	
1.8	Islamic Principles Can Make the Difference	11	
1.9	Regulating Trade and Business	13	
1.10	Islamic Finance Passing Significant Milestones	15	
1.11	Could it Work to Achieve the Objectives?	16	
1.12	About this Book	17	
2 Dist	inguishing Features of the Islamic Economic System	21	
2.1	Introduction	21	
2.2	Islamic Sharī'ah and its Objectives	21	
	2.2.1 Sources of Sharī´ah Tenets	21	
	2.2.2 Objectives (Maqāsid) of Sharī'ah	22	
2.3	Why Study Islamic Economics?	25	
	2.3.1 The Role of Islamic Economists	27	
2.4	Islamic Economics: What should it be?	30	
	2.4.1 Islamic Economics Defined	31	
2.5	Paraphernalia of Islamic Economics	32	
	2.5.1 Ownership of Resources and Property Rights	33	
	2.5.2 Islamic Welfare Approach	34	

viii

		2.5.3	The Factors of Production	35
			Restrained Individual Freedom	37
			Liberalism versus State Intervention	38
	2.6	Sumn		41
			•	
3	The	Main P	Prohibitions and Business Ethics in Islamic	
	Econ	nomics a	and Finance	43
	3.1	Introd	luction	43
	3.2	The E	Basic Prohibitions	43
		3.2.1	Prohibition of Riba	44
		3.2.2	Prohibition of Gharar	57
		3.2.3	Prohibition of Maisir/Qimār (Games of	
			Chance)	61
	3.3	Busin	ess Ethics and Norms	64
		3.3.1	Justice and Fair Dealing	64
		3.3.2	Fulfilling the Covenants and Paying	
			Liabilities	67
		3.3.3	Mutual Cooperation and Removal of	
			Hardship	68
		3.3.4	Free Marketing and Fair Pricing	68
		3.3.5	Freedom from Dharar (Detriment)	69
	3.4	Sumn	nary and Conclusion	70
4	The	Philoso	phy and Features of Islamic Finance	73
	4.1	Introd	luction	73
	4.2	The P	Philosophy of Islamic Finance	73
		4.2.1	Avoiding Interest	74
		4.2.2	Avoiding Gharar	75
		4.2.3	Avoiding Gambling and Games of Chance	76
		4.2.4	Alternative Financing Principles	76
		4.2.5	Valid Gains on Investment	78
		4.2.6	Entitlement to Profit – With Risk and	
			Responsibility	81
		4.2.7	Islamic Banks Dealing in Goods not in Money	82
		4.2.8	Transparency and Documentation	83
		4.2.9	Additional Risks Faced by Islamic Banks	84
	4.3	Debt	versus Equity	85
	4.4	Islam	ic Banking: Business versus Benevolence	86
	4.5	Excha	ange Rules	87
	4.6	Time	Value of Money in Islamic Finance	89
	4.7	Mone	ey, Monetary Policy and Islamic Finance	90
		4.7.1	Status of Paper Money	91
		4.7.2	Trading in Currencies	91
		4.7.3		92
		4.7.4	Currency Rate Fluctuation and Settlement	
			of Debts	94
	48	Sumn	narv	96

Contents	ix
----------	----

PA	RT II	CONTRACTUAL BASES IN ISLAMIC FINANCE	99
5	Islam	ic Law of Contracts and Business Transactions	101
	5.1	Introduction	101
	5.2	Māl (Wealth), Usufruct and Ownership	101
		5.2.1 Defining Various Related Terms	103
	5.3	General Framework of Contracts	105
	5.4	Elements of a Contract	106
		5.4.1 Offer and Acceptance: Form of the Contract	106
		5.4.2 Elements of the Subject Matter	108
	5.5	Broad Rules for the Validity of Mu'āmalāt	110
		5.5.1 Free Mutual Consent	110
		5.5.2 Prohibition of Gharar	110
		5.5.3 Avoiding Riba	111
		5.5.4 Avoiding Qimār and Maisir (Games of Chance)	112
		5.5.5 Prohibition of Two Mutually Contingent Contracts	112
		5.5.6 Conformity of Contracts with the Maqasid of Sharī'ah	113
		5.5.7 Profits with Liability	113
		5.5.8 Permissibility as a General Rule	114
	5.6	W'adah (Promise) and Related Matters	114
		5.6.1 Token Money (Hamish Jiddiyah) and 'Arbūn	116
	5.7	Types of Contracts	117
		5.7.1 Valid Contracts	118
		5.7.2 Voidable (Fāsid) Contracts	120
		5.7.3 Void (Batil) Contracts	123
	5.8	Commutative and Noncommutative Contracts	124
		5.8.1 Uqood-e-Mu'awadha (Commutative Contracts)	124
		5.8.2 Uqood Ghair Mu'awadha (Tabarru') or Gratuitous Contracts	125
	<b>.</b> .	5.8.3 Legal Status of Commutative and Noncommutative Contracts	125
	5.9	Conditional or Contingent Contracts	126
	5.10	Summary	127
6	Trad	ing in Islamic Commercial Law	129
	6.1	Introduction	129
	6.2	Bai' – Exchange of Values	130
	6.3	Legality of Trading	131
		6.3.1 Trade (Profit) versus Interest: Permissibility versus Prohibition	132
	6.4	Types of Bai'	133
	6.5	Requirements of a Valid Sale Contract	133
		6.5.1 The Object of the Sale Contract	135
		6.5.2 Prices and the Profit Margin	138
		6.5.3 Cash and Credit Prices	139
	6.6	Riba Involvement in Sales	142
	6.7	Gharar – A Cause of Prohibition of Sales	143
	6.8	Conditional Sales and "Two Bargains in One Sale"	144
	6.9	Bai' al'Arbūn (Downpayment Sale)	145
	6.10	Bai' al Dayn (Sale of Debt)	146

x Understanding Islamic Finance	

	6.11	Al 'Inah Sale and the Use of Ruses (Hiyal)	147
	6.12	Options in Sales (Khiyar)	150
	6.13	Summary	152
7	Loan	and Debt in Islamic Commercial Law	155
	7.1	Introduction	155
	7.2	The Terms Defined	155
	7.3	Illegality of Commercial Interest	157
	7.4	Loaning and the Banking System	158
	7.5	Guidance from the Holy Qur'ān on Loans and Debts	159
	7.6	The Substance of Loans	159
	7.7	Repayment of the Principal Only	160
	7.8	Time Value of Money in Loans and Debts	160
	7.9 7.10	Instructions for the Debtor Instructions for the Creditor	161 162
		Husnal Qadha (Gracious Payment of Loan/Debt)	162
		Remitting a Part of a Loan and Prepayment Rebate	163
	7.12	Penalty on Default	165
	7.13	7.13.1 Insolvency of the Debtor	167
	7.14	Hawalah (Assignment of Debt)	167
	7.15	Security/Guarantee (Kafalah) in Loans	168
		7.15.1 Risk and Reward in Pledge	170
		7.15.2 Benefits from Pledge	171
	7.16	Bai' al Dayn (Sale of Debt/Debt Instruments)	172
	7.17		172
	7.18	Summary	174
PA	RT III	ISLAMIC FINANCE – PRODUCTS AND PROCEDURES	177
8	Over	view of Financial Institutions and Products: Conventional and	
	Islam	ic	179
	8.1	Introduction	179
	8.2	What is Banking or a Bank?	179
	8.3	The Strategic Position of Banks and Financial	
		Institutions	180
	8.4	Categories of Conventional Financial Business	181
		8.4.1 Commercial Banking	181
		8.4.2 Investment Banking	184
		<ul><li>8.4.3 Other NBFIs</li><li>8.4.4 Conventional Financial Markets</li></ul>	185
	8.5	The Need for Islamic Banks and NBFIs	185 185
	0.5	8.5.1 The Structure of Islamic Banking	186
		8.5.2 The Deposits Side of Islamic Banking	188
		8.5.3 Instruments on the Assets Side	191
	8.6	The Issue of Mode Preference	195
	8.7	Islamic Investment Banking	199

				Contents	xi
	8.8	Islami	c Financial Markets and Instruments		199
		8.8.1	Islamic Funds		201
		8.8.2	Principles Relating to Stocks		203
		8.8.3	Investment Sukuk as Islamic Market Instruments		204
		8.8.4	Trading in Financial Instruments		205
		8.8.5	Inter-bank Funds Market		205
		8.8.6	Islamic Forward Markets		206
		8.8.7	Foreign Exchange Market in the Islamic Framework		209
		8.8.8	Derivatives and Islamic Finance		209
	8.9	Summ	ary and Conclusion		211
9	Mura	abaha a	nd Musawamah		213
	9.1	Introdi	uction		213
	9.2		tions of Valid Bai'		214
	9.3	Murab	paha – a Baiʻ al Amānah		215
	9.4	Bai' M	Aurabaha in Classical Literature		215
	9.5	The N	eed for Murabaha		216
	9.6	Specif	ic Conditions of Murabaha		217
		9.6.1	Bai' Murabaha and Credit Sale (Murabaha-Mu'ajjal)		219
	9.7	Possib	le Structures of Murabaha		220
		9.7.1	Direct Trading by Bank Management		221
		9.7.2	Bank Purchases Through a Third Party/Agent		221
		9.7.3	Murabaha Through the Client as Agent		222
	9.8	Murab	paha to Purchase Orderer (MPO)		222
		9.8.1	MPO – A Bunch of Contracts		224
		9.8.2	Promise to Purchase in Murabaha		224
		9.8.3	MPO - The Customer as the Bank's Agent to Buy as	nd	
			Related Matters		225
	9.9	Issues	in Murabaha		229
		9.9.1	Avoiding Buy-back		230
		9.9.2	Khiyar (Option to Rescind the Sale) in Murabaha		230
		9.9.3	Time of Executing Murabaha		231
		9.9.4	Defaults by the Clients		231
		9.9.5	Rebates on Early Payment		232
		9.9.6	Rollover in Murabaha		232
		9.9.7	Murabaha Through Shares		233
		9.9.8	Commodity Murabaha		233
	9.10	Precau	ntions in Murabaha Operations		233
	9.11	Musav	vamah (Bargaining on Price)		234
		9.11.1	Musawamah as a Mode of Financing		238
	9.12	Summ	ary		238
10	Forw	ard Sal	es: Salam and Istisna'a		241
	10.1	Introdu			241
	10.2		alam/Salaf		241
	10.3	Benefi	its of Salam and the Economic Role of Bai' Salam		242
	10.4	Featur	es of a Valid Salam Contract		243

		10.4.1	Subject Matter of Salam	244
		10.4.2	Payment of Price: Salam Capital	246
		10.4.3	Period and Place of Delivery	247
		10.4.4	Khiyar (Option) in Salam	248
		10.4.5	Amending or Revoking the Salam Contract	248
		10.4.6	Penalty for Nonperformance	249
	10.5	Security,	Pledge and Liability of the Sureties	249
	10.6	Disposing	g of the Goods Purchased on Salam	250
		10.6.1	Alternatives for Marketing Salam Goods	251
	10.7	Salam – I	Post Execution Scenarios	252
		10.7.1	Supply of Goods as Per Contract	252
		10.7.2	Failure in Supply of Goods	253
		10.7.3	11 7	253
	10.8		sed Securitization – Salam Certificates/Sukuk	254
	10.9	•	of Salam Rules	255
	10.10		a Financing Technique by Banks	257
		10.10.1	Risks in Salam and their Management	258
	10.11		(Order to Manufacture)	263
		10.11.1	Definition and Concept	263
		10.11.2	Subject Matter of Istisna'a	264
		10.11.3	Price in Istisna'a	265
		10.11.4	Penalty Clause: Delay in Fulfilling the Obligations	266
		10.11.5	The Binding Nature of an Istisna'a Contract	266
		10.11.6	Guarantees	267
		10.11.7	Parallel Contract – Subcontracting	267
		10.11.8	Istisna'a and Agency Contract	268
		10.11.9		268
		10.11.10		269
		10.11.11	Risk Management in Istisna'a	269
11	Ijarah	- Leasing		279
	11.1	Introducti	on	279
	11.2	Essentials	s of Ijarah Contracts	280
		11.2.1	Ijarah and Bai' Compared	280
	11.3	General J	uristic Rules of Ijarah	281
		11.3.1	Execution of an Ijarah Contract	282
		11.3.2		283
		11.3.3	Sub-lease by the Lessee	284
		11.3.4	Security/Guarantee in Ijarah	285
		11.3.5	Liabilities of the Parties	285
		11.3.6	Termination/Amendment of the Contract and Implications	286
		11.3.7	Failure in Payment of Due Rent	287
	11.4		Jse of Ijarah	287
		11.4.1	Financial Lease or Hire–Purchase	288
		11.4.2	Security or Financing Lease	288
		11.4.3	Operating Lease	289
		11.4.4	Appraisal of Conventional Leases from the Sharī'ah Angle	289

		Contents	xiii
		11.4.5 Combining Two Contracts	289
		11.4.6 Takaful/Insurance Expenses	291
	11.5	Islamic Banks' Ijarah Muntahia-bi-Tamleek	291
		11.5.1 Procedure for Ijarah Muntahia-bi-Tamleek	293
		11.5.2 Issues Concerning Modern Use of Ijarah	295
		11.5.3 Assignment of the Leased Assets and Securitization of Lease	s 297
		11.5.4 Potential of Ijarah	297
	11.6	Summary of Guidelines for Islamic Bankers on Ijarah	298
12	Partici	ipatory Modes: Shirkah and its Variants	307
	12.1	Introduction	307
	12.2	Legality, Forms and Definition of Partnership	308
		12.2.1 Partnership in Ownership (Shirkatulmilk)	309
		12.2.2 Partnership by Contract (Shirkatul'aqd)	309
	12.3	Basic Rules of Musharakah	312
		12.3.1 Conditions with Respect to Partners	312
		12.3.2 Rules Relating to Musharakah Capital	313
		12.3.3 Mutual Relationship Among Partners and Musharakah	
		Management Rules	314
		12.3.4 Treatment of Profit and Loss	316
		12.3.5 Guarantees in Shirkah Contracts	318
		12.3.6 Maturity/Termination of Musharakah	318
	12.4	The Concept and Rules of Mudarabah	320
		12.4.1 The Nature of Mudarabah Capital	323
		12.4.2 Types of Mudarabah and Conditions Regarding Business	324
		12.4.3 Work for the Mudarabah Business	325
		12.4.4 Treatment of Profit/Loss	325
		12.4.5 Termination of a Mudarabah Contract	327
	12.5	Mudarabah Distinguished from Musharakah	327
	12.6	Modern Corporations: Joint Stock Companies	328
	12.7	Modern Application of the Concept of Shirkah	330
		12.7.1 Use of Shirkah on the Deposits Side of the Banking System	331
		12.7.2 Use of Shirkah on the Assets Side	332
		12.7.3 Securitization on a Shirkah Basis	334
	12.8	Diminishing Musharakah	337
	12.9	Diminishing Musharakah as an Islamic Mode of Finance	339
		12.9.1 Diminishing Musharakah in Trade	339
		12.9.2 Procedure and Documentation in Diminishing	
		Musharakah	340
	12.10	Summary and Conclusion	343
13	Some .	Accessory Contracts	347
	13.1	Introduction	347
	13.2	Wakalah (Agency)	347
		13.2.1 Types of Wakalah	347
		13.2.2 Wakalatul Istismār	349
	13.3	Tawarruq	349

xiv

		13.3.1	Use of Tawarruq for Liquidity Management	351
	13.4	Juʻalah		351
			Parties to Ju'alah	351
			Subject Matter of Ju'alah and Reward	352
			Execution of a Ju'alah Contract	353
			Parallel Ju'alah Contracts	353
			Practical Process in Ju'alah by Islamic Banks	353
		13.4.6	Some Islamic Financial Products Based on Ju'alah	354
	13.5	Bai' al	Istijrar (Supply Contract)	355
14	Applio	cation of	the System: Financing Principles and Practices	357
	14.1	Introdu	ction	357
	14.2	Product	Development	358
		14.2.1	Procedure for Product Development	358
	14.3	The Na	ture of Financial Services/Business	358
		14.3.1	Management of Deposit Pools and Investments	359
		14.3.2	Selection of the Mode for Financing	360
		14.3.3	Tenor of Financing	362
		14.3.4	Sharī'ah Compliance and Internal Sharī'ah Controls	363
			Operational Controls	367
	14.4	Prospec	ets and Issues in Specific Areas of Financing	369
		14.4.1	Working Capital Finance	369
		14.4.2	Trade Financing by Islamic Banks	370
		14.4.3	Project Financing	373
		14.4.4	Liquidity Management	374
			Forward Contracts and Foreign Exchange Dealings	375
		14.4.6	Refinancing by the Central Banks	377
		14.4.7	Cards: Debit, Charge, Credit and ATM	379
	14.5	Islamic	Banks' Relationship with Conventional Banks	384
	14.6	Fee-bas	ed Islamic Banking Services	384
		14.6.1	Underwriting	384
		14.6.2	Letters of Guarantee (L/G)	384
		14.6.3	Letters of Credit (L/C)	385
	14.7	Summa	ry and Conclusion	386
	Appen	dix: The	Major Functions of a Sharī ah Supervisory Board In the Light	
		of the A	AAOIFI's Sharī´ah Standard	387
15	Sukuk	and Sec	curitization: Vital Issues in Islamic Capital Markets	389
	15.1	Introdu		389
	15.2	The Ca	pital Market in an Islamic Framework	390
	15.3		zation and Sukuk	391
		15.3.1	Parties to Sukuk Issue/Securitization	393
		15.3.2		394
		15.3.3	1 1 /	395
		15.3.4	· · · · · · · · · · · · · · · · · · ·	396
		15.3.5		398
			Tradability of Sukuk	407

			Conter	nts xv
		15.3.7	Issues in Terms and Structures of Sukuk	409
		15.3.8	Potential of Sukuk in Fund Management and Developing t	he
			Islamic Capital Market	411
	15.4	Summa	ary and Conclusion	412
16	Takaf	ful: An A	Iternative to Conventional Insurance	417
	16.1	Introdu	ction	417
	16.2	The Ne	eed for Takaful Cover	417
		16.2.1	Why Conventional Insurance is Prohibited	418
	16.3	The Sh	arī´ah Basis of Takaful	420
		16.3.1	Main Objective of the Takaful System	422
	16.4	How th	ne Takaful System Works	422
			Models of Takaful	423
			Issues in the Mudarabah Model	426
		16.4.3	Issues in Wakalah and Wakalah-Mudarabah Models	426
	16.5		l and Conventional Insurance Compared	427
	16.6	Status a	and Potential of the Takaful Industry	428
	16.7		l Challenges	429
	Apper	ıdix: Fatā	wa (Juristic Opinions) on Different Aspects of	
		Insuran	ace	430
17	An A <sub>l</sub> Finan		of Common Criticism of Islamic Banking and	433
	17.1		ction	433
	17.1		ommon Myths and Objections	433
	17.2		sal of Conceptual Criticism	436
	17.5		The Connotation of the Word Riba	436
			Rent on Money Capital	437
			Inflation and Interest	438
			Time Value of Money and Islamic Banking	439
			Charging Interest from Rich Debtors	441
			Different Sharī ah Interpretations	441
			Islamic Banks Using Debt-creating Modes	442
		17.3.8	Islamic Financial Institutions – Banks or Trade	
			Houses?	444
		17.3.9	Islamic Banks to Act as Social Welfare Institutions?	445
	17.4		sal of Criticism on Islamic Banking Practice	445
		17.4.1	Divergence between Theory and Practice	445
		17.4.2	IFIs using Interest Income as Seed/Base Capital	446
		17.4.3	Difference between Islamic and Conventional Banking	447
		17.4.4	Imposing Penalties on Defaulters	454
		17.4.5	Availability of Cash for Overhead Expenses and Deficit	
			Financing	455
		17.4.6	Socio-economic Impact of the Present Islamic Banking	
			System	455
	17.5	Conclu	sion	456

### xvi Understanding Islamic Finance

18	The V	Way Forward	457
	18.1	Introduction	457
	18.2	Agenda for the Policymakers	457
		18.2.1 Muslim States and Islamic Finance	459
	18.3	Potential, Issues and Challenges for Islamic Banking	461
		18.3.1 Promising Potential	463
		18.3.2 Issues in Islamic Finance	465
		18.3.3 The Challenges	<b>47</b> 4
	18.4	Conclusion	479
Acr	onyms		481
Glo	ssary		485
Bib	liograp	ohy English Sources	497
Ara	bic/Ur	du Sources	503
Sug	gested	Further Readings	505
Ind	ex		509

## List of Boxes and Figures \_\_

### Boxes

8.1	Deposit Management in Islamic Banks on Mudarabah Basis	190
8.2	Islamic Banking Products and Services	194
8.3	Islamic Capital Market Instruments and Operations	207
9.1	Risk Management in Murabaha	234
9.2	Possible Steps for Murabaha in Import Financing	235
9.3	Accounting Treatment by Islamic Banks in Murabaha	236
9.4	Murabaha Financing for Exports: Process and Steps	237
10.1	Flow of Salam Transactions by Banks	256
10.2	The Difference between Salam and Murabaha	257
10.3	Possible Risk Mitigation in Salam	258
10.4	Case Study	259
10.5	Salam – Preshipment Export Financing	260
10.6	Salam and Refinance by the Central Banks (CBs)	260
10.7	Salam for Working Capital Finance	261
10.8	Accounting Treatment by Islamic Banks in Salam and Parallel Salam	262
10.9	Risk Mitigation in Istisna'a	270
10.10	Differences between Istisna'a and Salam and Ijarah (Ujrah)	270
10.11	Accounting Treatment by Islamic Banks (as Seller) in Istisna'a	271
10.12	Accounting Treatment by Islamic Banks (as Buyer) in Istisna'a	273
10.13	Housing Finance through Istisna'a	274
10.14	Istisna'a for Preshipment Export Finance	275
10.15	Parallel Istisna'a for Building Project Finance	276
10.16	Parallel Istisna'a – Government Projects	277
11.1	Risk Mitigation in the Case of Ijarah	299
11.2	Auto Ijarah Compared with Conventional Leasing Products	300
11.3	A Hypothetical Case Study on Ijarah	301
11.4	Accounting Treatment of Ijarah	303
12.1	Rules Relating to Sharing of Profit/Loss in Shirkah	319
12.2	Case Study on the Use of Musharakah for Trade Financing	334
12.3	Musharakah-based TFCs Issued by Sitara Industries, Pakistan	335
12.4	Construction of a House on a Customer's Land or Renovation of a House	341

xviii	Understanding	Islamic	Finance

12.5	Hypothetical Case Study on Housing Finance Through Diminishing	
	Musharakah (Partnership by Ownership)	341
12.6	Accounting Treatment of Mudarabah (Financing Side)	344
12.7	Accounting Treatment of Musharakah	345
14.1	Salient Features of Major Modes of Financing	361
14.2	Example of Using Salam and Murabaha Combined	362
15.1	Developing Islamic Depository Receipts (IDRs)	390
15.2	Securitization Mitigates the Risks	395
15.3	Tradability of Sukuk in the Secondary Market	408
15.4	Prominent Sukuk Issues in Various Countries	408
15.5	DP World's Nakheel Sukuk	412
15.6	yyIjarah Sukuk Offering by the Government of Pakistan	413
15.7	Ijarah Sukuk Issue by WAPDA, Pakistan	414
15.8	Case Study of Hanco Fleet Securitization (Saudi Arabia)	414
16.1	Flowchart of the Wakalah with Waqf Model of Takaful	425
18.1	Sharī'ah Compliance Framework Introduced by the State Bank of Pakistan	473
Figur	was	
Figu	res	
6.1	Forms of Bai' with respect to counter values	134
6.2	Elements of valid Bai	135
13.1	The Ju'alah process	354
15.1	Flow diagram of the securitization process	394
15.2	Flow diagram of IDB mixed portfolio Sukuk issue, 2003	407

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 Sharī'ah (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.

M. Fahim Khan
Division Chief
Islamic Research and Training Institute
Islamic Development Bank
Jeddah, Saudi Arabia

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 Sharīʿah, 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 Sharī'ah scholars, creative work by research institutions like the IRTI (IDB) and the issuance of Sharī'ah 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 Sharīáh.

Bankers, the business community, industrialists, Sharīah 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.

Among those who accept the prohibition of interest, there are two approaches: according to the mainstream approach, IFIs can use both categories of Islamic modes, while some believe that Islamic banking, in letter and spirit, means only Shirkah-based transactions. The latter perception is that Islamic finance, which was originally conceived as a two-tier Mudarabah, has shifted to debt-creating modes that are almost similar to the interest-based products of the banks, and as such, Islamic banks' business also yields fixed returns as in the case of the interest-based system. According to the mainstream approach, however, the issue of mode selection is one of a preference for some over others and not one of prohibition of debt-creating/fixed-return modes, and hence IFIs can use both categories of modes subject to observance of the Sharī'ah rules relating to trade and lease transactions and keeping in mind the risk profile of the savers/investors and the nature of business, profitability and cash flow of the entrepreneurs seeking facilities from the Islamic banks.

The message this author intends to convey is that IFIs need to carefully observe the principles of Islamic finance with Sharīah inspiration while using any of the permitted modes. It is, however, a fact that an important factor determining the integrity of their operations, besides Sharī ah compliance and the professional competence of their incumbents, is the possible impact of Islamic banks' operations on the clients and the society or economy. A common question faced by the practitioners is whether the Islamic banking in vogue will be able to remove distortions created by the interest-based system, even in the long run. It requires, on the one hand, that the role of partnership modes and equity-based capital in Islamic banks' operations needs to be enhanced and, on the other hand, the stakeholders need to be educated and apprised that all Islamic modes can play a positive role in development and capital formation, if used by banks observing the Sharīah rules. Further, banking is only one part, though the most strategic one, of the overall system of finance and economics. Fiscal, credit and monetary policies of the states have a crucial impact on the financial business in any economy. This would require the creation of real-asset-based money only and promoting retail and corporate financial services on the basis of fair play and risksharing. Therefore, for sustainable and all-pervasive development of economies and the welfare of human beings as a whole, the real-asset-based system of finance with care for socio-economic ethics needs to be introduced gradually on a wider scale.

I hope that the work in hand will prove to be a useful source material for understanding the principles, modes and operations of Islamic finance for all those who want to have such knowledge, especially those who intend to apply it for providing Sharīáh-compliant solutions to investors and fund users.

I pray to the Almighty to accord His acceptance to this effort, made solely to spread knowledge about and promote observance of the injunctions of the Sharī'ah in economic and financial dealings, and make this book a means of disseminating the concept of Islamic banking and finance, forgiving me for any inadvertent errors and omissions.

Muhammad Ayub Director Training, Development and Shariah Aspects Institute of Islamic Banking and Insurance (IIBI) London

### Acknowledgements

Credit for this work primarily goes to my friend Riaz Ahmad, who introduced me to John Wiley & Sons, and to Caitlin Cornish, Senior Commissioning Editor for the Finance list at Wiley, who asked me to produce a textbook on Islamic finance. Other people at Wiley, who persistently persuaded me to carry on the work, include Emily Pears and Vivienne Wickham and the rest of the editorial staff of this wide-range publishing house. I am deeply obliged to all of them and also to the external reviewer who examined the first version of the manuscript and suggested the addition of a chapter "An Appraisal of Common Criticism of Islamic Banking and Finance", which added value to the book.

I have extensively benefited from the scholarly works of a number of institutions and individuals in the preparation of the book. The institutions include: the Islamic Fiqh Council of the OIC, Jeddah (their resolutions); the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Bahrain (Sharīáh and accounting standards); the Council of Islamic Ideology, Pakistan (report on elimination of interest from the economy, June 1980); the Federal Shariat Court, Pakistan (judgement on Riba, November, 1991); the Shariat Appellate Bench of the Supreme Court of Pakistan (judgement on Riba, December, 1999, along with scholarly discussions on all related issues).

A large number of publications of the Jeddah-based Islamic Development Bank's Islamic Research and Training Institute (IRTI) provided me with an extensive opportunity to study various conceptual and practical aspects of Islamic banking and finance. The institute deserves my deep appreciation and gratitude. I must gratefully appreciate the invaluable services of Dr Ahmad Mohamed Ali, President of the IDB, in rendering the IRTI a reference point for anyone desirous of understanding conceptual and operational contours of the emerging Islamic finance industry. The scholars associated with IRTI from whose works I especially benefited include: Dr M. Umer Chapra, Dr Mabid Ali Al-Jarhi, Dr Monzer Kahf, Dr M. Fahim Khan, Dr Munawar Iqbal, Dr Tariqullah Khan, Dr Ausaf Ahmad and Dr Habib Ahmed.

Scholarly works of a large number of other personalities also helped me a lot in the preparation of this book. I pay my profound gratitude to all of them. The following names come instantly to my mind: Dr Muhammad Nejatullah Siddiqi, Shaikh Siddiq M. Al-Amen Al-Dhareer, Justice Muhammad Taqi Usmani, Dr Wahbah Zuhayli, Dr Mahmoud Amin El-Gamal, Dr S.M. Hasanuz Zaman, Dr Abbas Mirakhor, Dr Mohammed Obaidullah, Dr Mohsin S. Khan, Dr Nadeem ul Haque, Dr Zamir Iqbal, Dr Ziauddin Ahmad and Dr M. Tahir Mansoori.

A large number of specialists and practitioners helped me to gain clarification on conceptual issues and practical aspects of Islamic banking and finance. I wish to record my thanks and gratitude to all of them. The following deserve special mention: Mr Hassan Kaleem, Sharīáh Advisor, Al Baraka Bank, Pakistan; Mr Muhammad Najeeb Khan, Sharīáh Advisor, Habib Metropolitan Bank, Pakistan; Mr Anwar Ahmad Meenai, Head Islamic Banking Division, National Bank of Pakistan; Mr Mohammad Sajid, CEO, JS Finance, Jahangir Siddiqi & Co., Karachi; Mr Ashar Nazim and team, The Capital Partners, Karachi; Mr Omer Mustafa Ansari, Ford Rhodes Sidat Hyder & Co., Karachi; Mr Muhammad Faisal Shaikh, Head Product Development, Bank Islami Pakistan; Mr Ahmad Ali, Head Product Development, Meezan Bank, Pakistan.

My very special thanks are due to Dr S.M. Hasanuz Zaman, former Chief, Islamic Economics Division of the State Bank of Pakistan and Ch. Rashid Ahmad Javed, former Director of the State Bank of Pakistan, who gave a thorough reading to a number of chapters of the book and suggested needed amendments/improvements.

While I am greatly obliged to all of the above-mentioned institutions and scholars, I am solely responsible for any inadvertent mistakes.

I would also like to record my thanks to Mr Riaz Riazuddin, Economic Advisor, State Bank of Pakistan, who encouraged me to take up the Wiley project I was initially hesitant to accept because of my official responsibilities at the State Bank and the volume of work required to accomplish the job. I would be rather ungrateful if I did not take this opportunity to pay thanks to the State Bank of Pakistan and its training arm (the National Institute of Banking and Finance, or NIBAF), where together I spent 27 years and got the opportunity to pursue my research work in Islamic economics, banking and finance.

Mr Bashir Ahmad Zia, Chief Librarian, and other staff of the library of the State Bank of Pakistan also deserve my gratitude for providing me the opportunity to consult books and journals from time to time. Their facilitation helped me a lot in the completion of the project. Indeed, I am deeply obliged to all of them.

Last, but not least, my thanks are also due to Muhammad Yousuf, my long-associated colleague at the State Bank and NIBAF, for composing and re-composing the manuscript and helping me to produce this work in an orderly manner.

Muhammad Ayub

Part I —	
Fundamentals	