Overview

Islamic finance has developed progressively over the last decade. Its popularity continues to grow at an exceptional rate. This unprecedented interest in Islamic finance globally can be attributed to the influence of religious faith among the Muslims, the increased adoption among Muslims to comply with the Muamalat aspects of their religion, the quest for better returns by financial intermediaries, a higher awareness among non-Muslims of this alternative financing, and growing acceptability in the Western society.

Philosophies Of Islamic Finance And Sharia Principles

The rules underlying the Islamic financial system are derived from the religion of Islam. These rules govern the conduct of all financial transactions and economic activities under the Islamic financial system. Its objectives and philosophies are required to be consistent with the Sharia, which is commonly referred to as ‘Islamic law’.

Sharia represents an amalgamation of principles derived from the primary sources: (1) Quran – according to Islamic tenets, a divine revelation by Allah the Almighty to His Messenger, Prophet Muhammad, on Allah's directives relating to society and the proper conduct of society's members, (2) Sunnah - the Prophet Muhammad's sayings, practice, sanctions and disapproval of things based on the Prophet's methodological application, explanation and implementation of the Quran; and the secondary sources, being inter alia: (3) Ijma- the unanimous consensus of qualified Muslim legal scholars in their interpretation and application of the teachings of the Quran and Sunnah and (4) Qiyas - the analogical deduction on some similar circumstances based on the provisions of the Quran and the Sunnah.

Sharia principles require financial transactions to be intertwined with genuine productive activities. There is specific emphasis on social justice, equity, fairness, risk sharing, property rights, economic development and optimum resources allocation in accordance with Sharia principles. Concentration of wealth in the hands of a few is prohibited by Sharia. Under Sharia, wealth must be circulated in a just manner and profits are shared according to risk taking. Sharia objectives and philosophies are consistent with the revelations found in the Quran and Hadith and represent the parameters for the conduct of business according to Islamic principles. Parallel to such objectives, Sharia has provided for several core prohibitions which must be strictly adhered to in contractual relationships, failing which, such contracts would be void and returns derived thereunder would be illegitimate in the eyes of Sharia. The prohibitions of riba (interest), gharar (uncertainty) and maisir (gambling) are the most fundamental prohibitions defining the validity of Sharia contracts.

Riba

Riba simply means a prohibited gain under Sharia. Riba would cover all gains from loans and debts, anything over and above the
principal amounts of loans and debts. For the purposes of this QuickCounsel, *riba* is construed simply as the prohibition of interest in the conventional sense, a concept prohibiting the making of money from money whether excessive or otherwise. Hence, a loan from the Islamic perspective must always be given free of any interest. Islamic finance predominantly relies on trading activities and the permanent or temporary transfer of ownership, usufruct, risk and liability relating to an asset. Therefore, the guiding principle of Islamic finance is the prohibition of interest-based lending, but capital providers and investors are not prevented from earning returns on their capital or investment appropriate to the duration of their commitment and exposure to risks. It is the exposure to risks over specific time periods that justify the earning of returns, which could be in the form of profits, rentals, fees or commission.

**Gharar & Maisir**

Gharar and maisir refer to uncertainty and gambling respectively. One of the underlying objectives of Islamic finance is to prevent dealings involving uncertainty, hazard, chance or uncontrollable risk leading to speculation. This is because uncertainty creates a sense of inequality at another's expense which runs contrary to the Islamic principles of equity, fairness and justice. Consistent with this prohibition, Islamic banks are not to engage in speculative trade in shares, short-selling, or trading in unidentified items. Derivatives of various kinds such as futures contracts, options, swaps and forward foreign exchange transactions where the rates are determined by interest differentials and fluctuation in currencies are similarly prohibited due to their speculative nature. Whilst these contracts may be perfectly acceptable in the conventional markets, the inherent volatility and uncertainties in such transactions cause the returns to be characterised as speculation, chance taking and gambling in the eyes of *Sharia*, thereby tainting the legitimacy of such returns under *Sharia*.

**Key Islamic Contractual Principles For Products In Islamic Finance**

Products offered in the Islamic financial system are commonly premised upon the following Islamic contractual principles: (1) *mudarabah*, (2) *musyarakah*, (3) *murabahah*, (4) *ijarah* and (5) *istisna*.

**Mudarabah**: A partnership for participation in profit whereby capital is provided solely by one party whilst the labour (management of the venture) is provided by another party. Any profit arising from the venture would be shared between the two parties according to a pre-agreed ratio. All losses are borne by the capital provider whilst the worker receives no remuneration. This type of contract is commonly used for liability products of Islamic banks in Malaysia, in the form of investment accounts which is the Islamic finance alternative to savings and fixed deposit accounts.

**Musyarakah**: Similar to *mudarabah*, this is a concept of joint venture, except that all parties contribute towards the capital. Profits are shared on a pre-agreed ratio whilst losses are shared according to the proportion of capital contribution of each partner. The *Musyarakah* is akin to a partnership contract. In Malaysia, the concept of *Musyarakah Mutanaqisah* (diminishing partnership) is currently a very popular underlying *Sharia* contract used for both corporate and retail property financing.

**Murabahah**: This refers to a sale of a commodity at a sale price that is fixed with specific reference to the cost of the commodity and a profit (mark-up) margin. The cost and profit margin must be expressly disclosed to the buyer. Payment of the price by the buyer to the seller can be made on a spot or deferred basis. Deferred payment *murabahah* transactions form the basis for the *Bai-Bithaman Ajil (BBA)* financing commonly employed in Malaysia. Another type of deferred payment *murabahah* financing is the *Commodity Murabahah* financing made popular by the establishment of the *Bursa Suq Al-Sila*, which is a commodity trading platform in Malaysia. The *Commodity Murabahah* concept is also used for deposit placements with Islamic banks.

**Ijarah**: This entails a leasing arrangement involving the transfer of the usufruct of a particular property to another person in exchange for rental payments from that person. The *Ijarah* is generally the accepted Islamic contract for financing equipment, machinery and vehicles.

**Istisna**: This is an agreement where the purchaser requests the seller (either on its own or by procuring some third party to do so) to manufacture, assemble or construct a subject matter for a specified price and to be delivered at some future date agreed upon between the seller and the purchaser. It is commonly used for financing works-in-progress such as contracts for the manufacturing of bespoke products and construction of major infrastructure, commercial and industrial projects.

Two or more Islamic contracts can be combined to develop Islamic finance products, provided the Islamic contracts are not interdependent.
Challenged Unique to Islamic Finance

Whilst the Islamic financial market has been growing phenomenally, the development of jurisprudence on Islamic finance within the existing legal system has not kept pace. Some key challenges are discussed below.

Human Resources

Human capital is the most important resource for any service industry. Due to the immense growth of Islamic finance, the demand for qualified people exceeds available supply. Islamic finance practitioners need to comprehend not only complex financing issues but also appreciate Islamic rules and concepts, core prohibitions, and the distinction between legitimate returns and illegitimate gains both in form and in substance from the *Sharia* perspective.

A pre-requisite to the aforesaid understanding is a working knowledge of the *Sharia* rules applicable to Islamic finance and the Islamic principles derived from the *Quran*, *Sunnah*, *Ijma* and *Qiyas* and the subsequent interpretations of such principles by Islamic scholars. This body of knowledge cannot be acquired overnight, but rather must be learned through systematic programs and education backed by institutional support and funding as well as on the job experiences.

Islamic finance products need to be vetted by Sharia scholars for Sharia compliance. The services of Sharia scholars are therefore highly in demand. Product innovation can only progress in parallel with an increase in qualified Sharia scholars who have a good understanding of commercial issues and competent talents in other areas of Islamic finance, such as Islamic product development specialists, Islamic banking legal practitioners and experts in risk evaluation specific to Islamic finance.

Product Innovation and Financial Engineering

In order to compete head-on with conventional finance, Islamic financial institutions need to grow in size and broaden the suite of *Sharia* compliant products to match the type of products and instruments available under conventional finance. Islamic financial products must be on par with, if not better than, conventional finance in terms of diversity, cost effectiveness and ability to meet the risk and return requirements of customers, whilst remaining *Sharia* compliant. It would not suffice to merely mimic conventional products and label them as 'Islamic' in form alone. Innovative products and competitive pricing are key drivers for capturing market share.

Islamic financial instruments are faced with pricing difficulties given that they cannot be associated with interest. The continuous practice of benchmarking against inter-bank offered rates will only fortify the common perception that Islamic financing is merely so in form and not in substance. Although there is a need for the Islamic financial industry to come up with an Islamic indicator which is *Sharia* compliant for benchmarking of Islamic products, the Islamic finance industry is struggling to achieve this given the dominance of the conventional benchmark in the economy.

On the positive side, the development of Islamic bonds, or *sukuk*, has given investors an alternative form of investment. Sukuk represents a trust certificate comparable to collective investment scheme that grants investors a share in the underlying asset along with the cash flow and risks that commensurate with such asset. It represents one of the most successful innovations in Islamic finance. Although the size of the *sukuk* market is modest in comparison to the global bond market, the *sukuk* market has experienced phenomenal growth in recent years due to funding needs for large infrastructure / construction projects and demand from investors in the Gulf States and other Islamic countries that require the *Sharia* compliant products.

Sharia Incongruency

After the demise of the Prophet Muhammad, there was no further Islamic revelation for humankind. Thereafter, *Sharia* developed through the process of scholastic interpretations (*Ijtihad*) such as *Ijma*, *Qiyas* and other methodologies undertaken by Islamic scholars based on the *Quran* and *Sunnah*. This in turn led to the emergence of various schools of Islamic jurisprudence. Consequently, differences in interpretation of *Sharia* arose over time resulting in four main schools, or *mazhab*, namely *Hanafis*, *Shafi'is*, *Malikis* and *Hanbalis*. Muslim believers in different geographical locations follow different schools.

The differences of interpretation of *Sharia* by the different schools have led to the subject of harmonization in Sharia interpretation. Some say that the divergence is unavoidable given that the views of each school are influenced by the circumstances, culture, politics, economy and social belief of a particular geographical location. What is appropriate for one country may not be suitable for another. In addition, the views of one school are not binding on another school. Mere product innovation without harmonization of
Sharia interpretation will not suffice. Differing or opposing Sharia interpretations can lead to legal uncertainties and affect investors’ confidence. Sharia incongruency makes it difficult for financial intermediaries to structure cross-border transactions or develop new products with global appeal. There is therefore an urgent need for a common understanding and acceptance of applicable Sharia rules and standards to enable Islamic finance to become truly global in its reach.

Risks Unique to Islamic Finance

Although Islamic finance is not directly affected by interest and exchange rate fluctuations, there is considerable financial risk through capital losses due to failed ventures and depreciating asset value during market turmoil. In times of economic crisis, notwithstanding proper monitoring system, investors in Islamic finance products are not immune to volatile economic forces and are exposed to similar concerns such as illiquidity, credit crisis and overall economic risk.

Although Islamic finance prohibits riba, unfavourable fluctuations in commodity prices, currency and interest rates will concern many Islamic bankers. For instance, the mark-up price used in Murabahah contracts will be indirectly affected due to changes in the various inter-bank offered rates for which Islamic banks use as a benchmark for pricing purposes.

Any risk of non-Sharia compliance of Islamic financial products will affect the legitimacy of all returns derived thereunder from the Islamic perspective. It could cost the Islamic banks monetary and reputational loss in the event any of their products are found to be non-Sharia compliant. This could occur when the Islamic banking documents do not accurately reflect the product structure or the mechanics of the underlying Sharia transactions. Such risk could be attributable to the failure of internal processes, monitoring and compliance systems within the Islamic banks. In Malaysia, new Sharia products must first be approved by the Islamic bank’s in-house Sharia committee before being approved by Bank Negara Malaysia (central bank of Malaysia) under advice of its Sharia Advisory Council.

Legislative and Regulatory Framework

The existing legislative and regulatory frameworks of many countries do not expressly cater to Islamic finance. As such, Islamic finance products are cautiously developed by Islamic banks, delicately balancing legislative challenges and legal uncertainties. As Islamic finance products become more popular, governments in both Islamic and non-Islamic countries have taken an active role with new legislative enactments and revisions to existing legislation to facilitate the growth of Islamic finance in their respective countries, most notably in taxation and stamp duty laws. Whilst awaiting law reform to close current legislative gaps, a great deal of innovation is required to counter legislative setbacks to Islamic products and security structuring.

There is also distinct disjunction between established conventional laws and Sharia rules which needs to be reconciled when structuring Islamic finance products. For example, the waad or unilateral promise concept is recognized and enforceable under Sharia laws, but its recognition and enforcement is not entirely clear cut under conventional laws. Here is where legal innovation comes into play to ensure the enforceability of the waad under conventional laws.

Compared to conventional finance, Islamic finance is relatively at its infancy stage in most countries. As such, the body of "Islamic finance specific" case law is relatively small. Judges who may not be familiar with the technicalities of Islamic finance are faced with the mammoth task of ensuring equity and fairness by innovating on established legal rules to apply to Islamic finance disputes. Sharia scholars may or may not be called to give expert evidence on Sharia, and even if called, there are challenges reconciling Sharia with conventional laws practiced by most countries. In Malaysia, it is mandatory for judges and arbitrators to refer any question on Sharia matters to the Shariah Advisory Council of Bank Negara Malaysia by virtue of the Central Bank of Malaysia Act 2009. Sharia rulings issued by the said Shariah Advisory Council are binding on the referring court or arbitrator.

The forum for effective alternative dispute resolution for Islamic finance is similarly lacking, although the practices of arbitration ("tahkim") and mediation ("sulh") are recognized under Sharia. In Malaysia, the Kuala Lumpur Regional Centre for Arbitration (KLRCA) has established a separate set of rules for Islamic Banking and Financial Services Arbitration.

Information Technology Constraints

The information technology ("IT") systems and platforms for Islamic finance are undeveloped when compared to the well-established and wide array of IT solutions for conventional finance. Although IT solutions for front-desk services and delivery channels of Islamic finance would probably not differ much from conventional finance, the IT systems and platforms for returns calculation must be customized to Islamic finance. The existing IT systems and platforms based on interest and the time value of money may not
comfortably fit Islamic finance products, which require very different calculation methodology depending on the *Sharia* principles governing the products. There is still much to do to produce automated IT solutions geared towards returns computation peculiar to Islamic finance, such as calculation of profits, lease rentals, commission and fees.

**Conclusion**

A strong financial system needs to be supported by a strong regulatory and legal framework that can effectively discourage undue risk-taking behaviour. It must also have adequate standards for effective risk management, financial disclosure standards and governance. These are areas for development to bring Islamic finance to the next level of exponential growth. Despite the challenges, the Islamic finance industry has grown to become a viable alternative for many, whether for reasons of personal faith or economic grounds.

**Government Resources**

- BNM - Bank Negara Malaysia
- MIFC - Malaysia International Islamic Financial Centre
- AIBIM - Association of Islamic Banking Institutions, Malaysia
- ISRA - International Shariah Research Academy For Islamic Finance
- IFSB - Islamic Financial Services Board
- Bursa Suq Al-Sila

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