Introduction to Islamic Banking & Finance

Brian Kettell
## Contents

Chapter 1. Muslim beliefs ................................................................. 13  
  Five pillars of faith .................................................................. 14  
    1. Profession of Faith ......................................................... 15  
    2. Five Daily Prayers .......................................................... 15  
    3. Zakat or almsgiving ....................................................... 16  
    4. Saum or fasting ............................................................ 16  
    5. Pilgrimage to Mecca ...................................................... 16  
  Six Islamic Creeds .................................................................. 18  
    Definition of Iman .............................................................. 18  
    Iman as basis of righteous deeds ....................................... 18  
    1. Belief in Allah and his attributes .................................... 18  
    2. Belief in Destiny (Qada’ar) ............................................ 20  
    3. Belief in angels ............................................................ 20  
    4. Belief in apostles .......................................................... 21  
    5. Belief in the Revealed Books ......................................... 22  
    6. Belief in the Hereafter ................................................... 23  
Chapter 2. Sources of Sharia’a law: legal basis for Islamic banking .... 27  
  Definition of the Sharia’a ..................................................... 28  
  Allah is the law giver ........................................................... 28  
  Sources of the Sharia’a ......................................................... 29  
    Qur’an: the primary source of the Sharia’a ....................... 30  
    Sunnah: the second primary source of Sharia’a .................. 32  
Chapter 3. Definition of Islamic banking ....................................... 37  
  Conventional bankers and Islamic banking ......................... 38  
  Six key Islamic banking principles ....................................... 40  
    1. Predetermined payments are prohibited ....................... 40  
    2. Profit and loss sharing .................................................. 41  
    3. Making money out of money is not acceptable ............... 42  
    4. Uncertainty is prohibited .............................................. 42  
    5. Only Sharia’a approved contracts are acceptable .......... 43  
    6. Sanctity of contract ..................................................... 43  
  Definition of asymmetric information ................................... 44  
    Adverse selection ............................................................ 44  
    Moral hazard ................................................................. 44  
  Origins of asymmetric risk within Islamic banking ............... 45  
  Riba in the Qur’an and Sunnah or hadith ............................ 46  
    Textual evidence for the ban on interest ......................... 47  
    Source of the ban on interest .......................................... 48
Islamic rationale for banning interest (riba) ................................................................. 49

Five reasons for the prohibition of *riba* ................................................................. 49
1. Interest is unjust ........................................................................................................ 49
2. Interest corrupts society .......................................................................................... 51
3. Interest implies unlawful appropriation of other people's property ..................... 51
4. Interest-based systems result in negative growth .................................................. 52
5. Interest demeans and diminishes human personality ............................................. 52

Chapter 4. *Murabaha* as a mode of Islamic finance ............................................. 55

*Murabaha* transactions .......................................................................................... 56
Definition of *Musawama* ......................................................................................... 57
Some terminological issues ....................................................................................... 58

What makes *Murabaha* *Sharia'a* compliant? ....................................................... 58

Islam treats money and commodities differently ..................................................... 59

*Commodity transactions with credit can involve an excess* .................................. 60

*Murabaha* and the *Sharia'a* .................................................................................. 61

Practicalities of implementing *Murabaha* ............................................................... 61

*Sharia'a* rules concerning *Murabaha* .................................................................... 63

Reasoning behind *Sharia'a* rules ............................................................................. 64

*Important exceptions to Sharia'a rules* ................................................................... 64

Practical examples of the application of *Murabaha* ................................................ 65
1. Mortgages .................................................................................................................. 65
2. Provides working capital ......................................................................................... 65
3. *Murabaha* and syndicated credits ......................................................................... 65
4. Financing of GSM licences ....................................................................................... 66
5. *Murabaha* used with letters of credit .................................................................. 66
6. *Murabaha* used for car and house purchase ....................................................... 67

Key issues associated with *Murabaha* .................................................................. 67
1. Use of interest rate as a benchmark ....................................................................... 68
2. Gharar issues ............................................................................................................ 69
3. *Collateral provisions against the Murabaha payment* ....................................... 71
4. Guaranteeing the *Murabaha* ................................................................................ 71
5. Penalty of default .................................................................................................... 71
6. No roll-over in *Murabaha* .................................................................................... 73
7. Rebate on earlier payment ...................................................................................... 73
8. Subject matter of *Murabaha* ................................................................................ 74
9. Rescheduling of the payments in *Murabaha* ....................................................... 74
10. Securitisation of *Murabaha* ................................................................................ 74

Comparison of *Murabaha* with interest-based finance ......................................... 75

*Murabaha* differences from the other Islamic financing techniques .................... 75
1. Islamically permissible deferred sales .................................................................... 75
2. Profit and loss share (PLS) contracts ...................................................................... 76

Summary ..................................................................................................................... 77

Chapter 5. *Mudaraba* as a mode of Islamic finance ............................................. 79

Definition of *Mudaraba* ......................................................................................... 80
Types of *Mudaraba* ................................................................................................. 81
Introduction to Islamic Banking & Finance

Sbaria’a rules concerning parallel Salam .......................................................... 152
Practical examples of Salam ............................................................................. 153
Benefits of the Salam contract ....................................................................... 153
Problems associated with Salam .................................................................... 154
Comparison of Salam with the conventional banking equivalent ................. 154
Salam: differences from the other Islamic financing techniques .................. 154
  1. Islamically permissible deferred sales.................................................... 154
  2. Profit and loss share (PLS) contracts...................................................... 155
  Differences between Salam and istisna’a .................................................. 156
Summary .......................................................................................................... 157
References ...................................................................................................... 159

Chapter 10. Takaful: Islamic insurance ............................................................ 161
Case for Islamic insurance ............................................................................. 162
Islamic issues with conventional insurance .................................................. 162
  Issues in conventional insurance .............................................................. 162
Definition and concept of Takaful ................................................................. 163
  How Tabarru’ eliminates the problems of conventional insurance ............ 163
  Derivation of the term Takaful or Islamic insurance ................................. 164
Islamic origins of Takaful ............................................................................. 164
Where insurance fits within Islam ................................................................. 165
Definition of the parties to a Takaful .............................................................. 165
Takaful in practice .......................................................................................... 166
Takaful and conventional insurance .............................................................. 166
Alternative models of Takaful ........................................................................ 167
  1. Ta’awun model...................................................................................... 167
  2. Non-profit model.................................................................................. 168
  3. Mudaraba model.................................................................................. 168
  4. Wakala model..................................................................................... 168
  Applying the relevant model .................................................................... 168
Sbaria’a law as applied by Takaful companies ............................................... 169
  1. Principles of contract.......................................................................... 169
  2. Principles of liability............................................................................ 169
  3. Principle of utmost good faith............................................................... 170
  4. Principles of Mirath and Wasiyab........................................................ 170
  5. Principles of Wakala (agency)............................................................... 170
  6. Principles of Dhaman (guarantee)......................................................... 170
  7. Principles of Mudaraba and Musharaka............................................... 171
  8. Principles of rights and obligations....................................................... 171
  9. Principles of humanitarian law............................................................. 171
  10. Principles of mutual co-operation....................................................... 172
Takaful companies ......................................................................................... 172
Definition of ReTakaful or reinsurance .......................................................... 172
ReTakaful ...................................................................................................... 172
Role of the Sbaria’a board in Takaful ............................................................. 175
Chapter 11. Sharia'a law and Sharia'a boards: roles, responsibility and membership .................................................. 177

Objectives of the Sharia'a .................................................. 178

Sharia'a: the framework of Islamic banking .......................... 178

Compliance with the scheme of Sharia'a laws ......................... 181

Sharia'a Islamic investment principles .................................. 181

Conditions for investment in shares ..................................... 182

Sharia'a supervisory board (SSB) ......................................... 183

Function and responsibilities ............................................. 183

Sharia'a boards: roles and scope of responsibilities ............... 184

Dubai Islamic Bank (DIB) .................................................. 186

Sharia'a board scholar qualifications ................................... 187

Dr Hussain Hamid Hassan ................................................. 187

Dr Ali AlQaradaghi .......................................................... 188

Dr Mohamed Elgari .......................................................... 188

Dr Mobd. Daud Bakar ....................................................... 188

Sheikh Nizam M.S. Yaquby ............................................... 189

Sheikh Muhammed Taqi Usmani ......................................... 189

Sheikh Abdullah Bin Suleiman Al-Maniya .......................... 190

Sheikh Dr Abdullah bin Abdulaziz Al Musleh ..................... 190

Sheikh Dr Muhammad Al-AIi Al Qari bin Iid .................... 190

State Bank of Pakistan (SBP): proper criteria for appointment of

Sharia'a advisors .......................................................... 191

Solvency and financial integrity ......................................... 191

Integrity, honesty and reputation ...................................... 191

Appendix 1. World's 100 largest Islamic banks .................... 193

Appendix 2. Top 500 Islamic Financial Institutions ............... 203

Glossary ................................................................. 232

References and bibliography ............................................ 239