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Working Paper *in* SSRN Electronic Journal · January 2010

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March 2010

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A Brief Review & Introduction to Practiced Islamic Banking & Finance

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Abstract

This paper looks at the practiced Islamic finance and alternatives it offers for corporate finance managers in sourcing funds i.e. i) Ijara ii) Murabaha iii) equity modes like Musharakah and Mudarabah iv) Diminishing Musharakah, v) Salam and vi) Istisna. It also looks at alternatives for sourcing funds from savers to provide financing thereof by financialintermediaries i.e. i) Qard-e-Hasan ii) Musharakah and iii) Mudarabah. The paper also gives a brief account of literature on Islamic corporate finance, interest free finance, alternatives suggested in the past and their pros and cons, role of central bank in Islamic finance and alternatives for OMO, Interbank lending and money market in Islamic finance.

Keywords: *Islamic corporate finance, pricing of capital, interest free finance, Interest, Interest free economy, Usury, Time value of money, Riba, Musharakah, Mudarabah, Ijara, Salam, Istisna, Qard-e-Hasan, Diminishing Musharakah.*

1. Introduction

The most distinguishing feature of the Islamic economic system is the prohibition of interest. Usury, Interest and Riba are synonymous terms but they have different technical meanings. Usury refers to the consumption loans given on higher rates and thus causing exploitation of the borrower. Interest refers to the cost of using money in finance and economic theory.

Interest is prohibited in all monotheist religions (See Exodus 22:25, Leviticus 25:35-36, Deuteronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12).

Islamic economic principles have prominently been applied in financial industry especially in banking. In Egypt, first Islamic savings bank was established based on the principle of profit-sharing at Mit Ghamr in 1963. The Islamic financial system in Malaysia was first introduced in

1963. It started from a modest beginning with the establishment of the Malaysian Pilgrims Fund Board (Tabung Haji), to the setting up of the country's first Islamic bank, Bank Islam Malaysia Berhad (BIMB), which commenced business on 1 July 1983.

In 1975, the Islamic Development Bank was established to provide financing to projects in the member countries. Dubai Islamic Bank was the first modern Islamic commercial bank founded in 1975. Indonesia's first Islamic bank was Bank Muamalat, which was established in 1991. In Bahrain, first Islamic commercial bank was established in 1978.

In Pakistan, Meezan Bank was the first Islamic commercial bank established in 2002. Since then, Bank Islami, Dubai Islamic Bank, First Dawood Islamic Bank, Bank Al-Barakah and Emirates Global Islamic Bank have started their operations as full fledged Islamic banks. The branch network of 6 full-fledged Islamic banks and 12 conventional banks (with dedicated Islamic banking branches-IBBs) increased to 528 branches by June 2009. It is estimated that Islamic banking will achieve a market share of 12 percent by 2012 in Pakistan. (Source: SBP Strategic Plan for Islamic Banking 2009).

Total assets of Islamic banking in Pakistan reached Rs. 313 billion by June 2009. The financing and investment portfolio of Islamic banks reached Rs. 195.0 billion by June 2009. In terms of market share, total assets, financing & investment and deposits reached 5.1 percent and 4.2 percent and 5.2 percent, respectively, at end June 2009. The deposit base of Islamic banks reached Rs. 238 billion at end-June 2009. (Source: Business Recorder, September 09, 2009). Lately, the Vatican said banks should look at the rules of Islamic finance to restore confidence amongst their clients at a time of global economic crisis. (Source: Osservatore, March 04, 2009).

Islamic Finance industry is a nascent but growing industry. Islamic financial industry beyond banking has achieved financial deepening in Mutual Funds industry, Investment Banking, Public Finance and insurance. On the geographical level too, Islamic banking has grown from Middle East to Europe and now is well positioned in South Asian markets as well.

In this paper, a brief introduction about the currently practiced Islamic Banking is provided.

2. Literature Review

Riba technically means "Any excess benefit derived on a loan over and above the principal". Therefore, definition of Riba encompasses interest and usury taken on consumption or commercial loans as well. However, there have been debates on whether the present day competitively set interest rate within a competitive financial industry comes under the interest that

was prohibited 14 centuries ago. But, this issue has been settled now that interest in all its forms and manifestations must not be allowed (Usmani, 2007).

Even among secular literature, one finds criticism on interest. Aristotle (384-322 BC) in his book “Politics” criticized interest in following words “Of all modes of getting wealth, this is the most unnatural". In value neutral economics too, we find criticism on interest. Keynes (1936, p. 377) in his monumental work “General Theory of Income, Employment, Interest and Money” reasoned in following words:

> “Interest to-day rewards no genuine sacrifice, any more than does the rent of land. The owner of capital can obtain interest because capital is scarce, just as the owner of land can obtain rent because land is scarce. But whilst there may be intrinsic reasons for the scarcity of land, there are no intrinsic reasons for the scarcity of capital. An intrinsic reason for such scarcity, in the sense of a genuine sacrifice which could only be called forth by the offer of a reward in the shape of interest, would not exist, in the long run, except in the event of the individual propensity to consume proving to be of such a character that net saving in conditions of full employment comes to an end before capital has become sufficiently abundant. But even so, it will still be possible for communal saving through the agency of the State to be maintained at a level which will allow the growth of capital up to the point where it ceases to be scarce”.

Siddiqui (2002) criticized interest stating that even in commercial loans, the borrower may suffer a loss, yet interest based lending obliges him/her to repay the principal plus compound interest. Conversely, the borrower may reap huge profits, yet the lender gets only the stipulated rate of interest which may likely turn out to be small part of the actual profits. It results in inefficient allocation of society’s resources and increases the inequality in the distribution of income and wealth as it guarantees a continuous increase in the monies lent out, mostly by the wealthy, and puts the burden of bearing the losses on entrepreneurs and through loss of jobs on the workers.

Chapra (2007) highlighting the benefits of asset backed financing by Islamic banks stated that Asset-based debt should further help by not allowing the debt to exceed the growth of the real economy. The introduction of such a discipline carries the potential of helping realize not only greater stability, but also greater efficiency and equity in the financial system.

Smolarski et al. (2006) analyzed options from Islamic point of view and argued that Options may be permitted for hedging purposes in Islamic finance as long as the underlying economic activities are themselves permissible from an Islamic point of view.

Mehmood (1990) introduced the TMCL model which is based on the basic idea that in a loan arrangement, both the amount of loan and time to maturity are equally important. Thus, if the amount of any loan is multiplied by the period for which it is extended, the result would be a unit i.e. loan value (LV). Thus an amount of Rs. 1000 for one year, has the same loan value as Rs.125 for eight years i.e. both sum upto the same loan value of Rs.1,000. Therefore, any combination of giving bilateral loans whereby the loan value remains same is in conformity with Islamic principles as it will fall in the realm of Qard-e-Hasan. Therefore, if a borrower needs a loan of Rs.1,000 for one year, he can give away a loan of Rs.125 for eight years and get a loan of Rs.1,000 for one year.

Zaheer (1996) criticized TMCL concept arguing that TMCL is based on the premise that money ought to have time value, the Islamic prohibition of Riba requires that money should not be allowed to have any time value at all. Consequently, the TMCL proposal is contributing to resurrect exactly the same evil which Quran wants to see condemned to extinction.

Time value of money is the problem of the lender. It is not the problem of the borrower. Lender can not demand any compensation or the opportunity cost. The borrower can not be obliged to pay the opportunity cost other than the principal amount. Interest rates in a given country are a function of many things other than just domestic inflation. Cost-push inflation is driven by supply shocks. Therefore, deterioration in real purchasing power is caused by factors not in the control of the borrower. He can not be held liable to compensate in a matter in which he was not responsible. Furthermore, inflation is measured by an index which has an urban bias, period bias and representative bias inherently. If indexation is permitted, we will have to index compensation to other factors of production e.g. wages, rent etc.

Interest free commercial banking has been introduced in many countries since decades. However, limited attention has been paid on the role and functions of the regulator itself and the way in which it can perform its functions in leading the way for Islamic monetary system. In the following lines, we analyze academic literature on interest free central banking in Islamic economics.

Interest free banking has been introduced in many Muslim countries since 1960. It has widened in scope, size, sophistication and reach ever since then. In academic literature relevant to the role and functions of central bank and monetary management based on Islamic ideals, we find concepts such as refinance ratio (Siddique, 1982), Qard-e-Hasan ratio (Khan, 1982), Mudarabah based lending between commercial and central banks and restricting high powered money by

way of RRR than relying on OMO (Chapra, 1983), Time Multiple Counter Loan (Mehmood, 1991), composite stock (Zangeneh & Salam, 1993) and central bank having equity stake in commercial banks (Uzair, 1982) to name a few.

Debt financing is a double-edge sword. Leveraged companies can magnify their returns in booms, but in slumps, they lose the edge and can even go bankrupt and make both their shareholders and creditors suffer. Debt financing results in a zero-sum game in which at least one stakeholder i.e. shareholders or creditors suffer. Equity financing ensures normal returns in booms and survival in slumps. Therefore, the company will not be squeezed of liquidity as interest expense as an 'autonomous expense' will not feature as a significant portion of total operating expenses.

A simplified economic model will highlight the point that equity financing is less risky and better prone to give profitable results in boom and also in recession. Keeping in view Efficient Market Hypothesis, profitability would be reflected in market prices.

Non-Leverage Company			
Assets	Rs. (in millions)	L + O.E	Rs. (in millions)
F.A	60	Debt	0
C.A	40	Equity	100
Total Assets	100	*Total L + O.E*	100

Case 1: Economic Boom Income Statement (Non-Leverage Company)		Case 2: Economic Recession Income Statement (Non-Leverage Company)	
	Rs in mln		Rs in mln
Net Sales	100	Net Sales	60
CoGS (70% of sales)	70	CoGS (70% of sales)	42
Gross Profit	30	Gross Profit	18
Operating Expenses	10	Operating Expenses	10
PBIT	20	PBIT	8
Interest Expense (12%)	0	Interest Expense (12%)	0
PBT	20	PBT	8
Tax Expense (20%)	4	Tax Expense (20%)	1.6
Net Income	16	Net Income	6.4
ROE	16%	ROE	6.4%

A simplified economic model will highlight the point that debt financing can provide better profitability ratios in boom but it is more risky and less prone to give profitable results in recession. Keeping in view Efficient Market Hypothesis, profitability would be reflected in market prices.

Leveraged Company			
Assets	Rs. (in millions)	L + O.E	Rs. (in millions)
F.A	60	Debt	60
C.A	40	Equity	40
Total Assets	100	*Total L + O.E*	100

Case 1: Economic Boom Income Statement (Leveraged Company)		Case 2: Economic Recession Income Statement (Leveraged Company)	
	Rs in mln		Rs in mln
Net Sales	100	Net Sales	60
CoGS (70% of sales)	70	CoGS (70% of sales)	42
Gross Profit	30	Gross Profit	18
Operating Expenses	10	Operating Expenses	10
PBIT	20	PBIT	8
Interest Expense (12%)	7.2	Interest Expense (12%)	7.2
PBT	12.8	PBT	0.8
Tax Expense (20%)	2.56	Tax Expense (20%)	0.16
Net Income	10.24	Net Income	0.64
ROE	25.6%	ROE	1.6%

The model shows that in economic booms, leveraged companies are more profitable than non-leveraged companies, but in recessions, leveraged companies are less profitable and hence riskier than non-leveraged companies. Hence, leveraged companies are depending on the assumption that the economic boom will last indefinitely.

Modigliani & Miller (1963) argued that value of a levered firm is greater than the value of an unlevered firm. The difference in value comes from the tax benefit accruing to a levered firm. But, they ignored the bankruptcy costs and the case where even if a company is solvent, the economy may go through a recession.

Furthermore, if this tax benefit is provided to an unleveled firm by making dividends to be tax deductible; then, value of a levered firm may cease to have any extra value greater than an unlevered firm.

3. Assets: Financing, Advances & Investments

Assets are the financing and investments made by the bank for profit. Some of the important and often used financing products of Islamic banks are discussed below:

3.1 Diminishing Musharakah

In Diminishing Musharakah, the customer approaches the bank for joint purchase of an asset/property. Designated valuation agencies are consulted for the valuation of the asset/property. The seller of the property is paid by the bank and the bank and the customer enter into a Musharakah Agreement.

It is referred to as 'Diminishing Musharakah' because of the arrangement, the ownership stake of the tenant increases and that of the bank decreases or diminishes with the passage of time. The rent decreases as the ownership stake of tenant increases.

The share of the bank in asset/property is divided into units. These units are purchased by the customer periodically until he has purchased all units and becomes the sole owner of the asset/property. Rent is not charged immediately and is charged at the end of the month for the use of asset/property. Rent for at least one period is fixed. Unit price fixed for a period will not change during that period.

The rent is calculated based on 1 year KIBOR. KIBOR is used as there is no other benchmark rate available. The logical argument is that in a society if there is only one merchant who sells prohibited products, and then he starts to sell one legitimate product, he can use the profit rates on prohibited products for pricing and calculating profit margin on the legitimate product.

In Musharakah Agreement, the floor rate (minimum rate) and the ceiling rate (maximum rate) is stated based on which the rent can vary. In Musharakah agreement, it is stated that if payment is made on time, the transfer of ownership will take place accordingly.

The risk of damage to the property is borne by the bank and the customer, according to the stake in the property at the time of disaster. Just like in conventional mortgage, a penalty is charged if a customer withdraws from the contract that is paid to charity. The logical argument presented for such a penalty is that the contract involves a promise/undertaking to pay rent and purchase units of the asset/property and if a customer withdraws from the promise/undertaking, he can be asked to pay a penalty for maintaining financial discipline.

3.2 Murabaha

Murabaha is a sale transaction. Technically, it is a deferred payment sale. If a trader has a right to sell a good at a profit, the bank should also have the right to sell an asset if he obtains physical/constructive possession of the asset and bears the risks related to the property until the sale is made to the customer.

Murabaha is used in working capital financing, SME financing and trade financing. The customer is asked to buy the asset acting as an agent to the bank because he has more knowledge about the product and better relationships with the supplier to obtain the goods at a competitive price and in a timely and appropriate manner.

In the case of import/export, if the exporter does not know the buyer of the asset (importer or bank), it does not matter. If A takes a loan from the bank and buys an asset from B, B has no concern from where the money is coming from (the buyer's own pocket or the bank). B's only concern is getting the price he is selling for.

The Process flow of Murabaha is as follows:

Islamic bank and the client sign a Master Murabaha Finance Agreement and an agency agreement. According to the agency agreement, the customer purchases goods from the supplier on bank's behalf. The customer undertakes to purchase the asset from the bank. It is a one-sided promise and undertaking. The bank pays the supplier and obtains title and physical/constructive possession of the asset. The customer signs a declaration that he has purchased the goods on bank's behalf and now he is willing to purchase the asset. After offer and acceptance, sale is executed and the customer pays the agreed price to the bank.

Rollover i.e. rescheduling in Murabaha is not allowed. The goods cannot be sold if they are consumed already. Penalty is charged if payment is delayed and is paid to charity.

3.3 Ijarah

Ijarah means to give something on rent. In Ijarah, right of use of a property is transferred to another person for a consideration. The lease period starts when the asset has been delivered by the lessee in a usable condition. The bank (Lessor) bears the ownership related costs and the customer (Lessee) bears the usage related cost. Insurance, installation, import duty, delivery

charges are paid by the bank and are added in its cost and recovered through transfer pricing. If the asset is destroyed or becomes unusable, the bank stops taking rent and does not charge rent for that period. Penalty for late payment is charged for maintaining financial discipline and is paid to charity. The asset/property remains in the ownership of the bank until the bank sells the asset to the customer in a separate agreement. The client is not obliged to buy the asset at the end of the lease period.

The process flow is as follows:

The customer approaches the bank for obtaining an asset on lease. The customer undertakes to make periodic lease payments for the lease period. Lease agreement and agency agreement is signed. The customer as an agent to the bank buys the asset. Bank receives the title of the asset and pays the vendor. The bank leases the asset and the customer starts using the asset and pays rent for each period. In the end, the customer can purchase the asset from the bank by way of a separate purchase agreement.

3.4 Salam

It is used in financing goods and services that are not ready for spot sale and will have to be delivered later. In Salam, payment is spot, but the delivery is deferred. It is used in special cases to facilitate transactions. In current practice, it is used in currency trade as an alternative for bill of exchange discounting and in agriculture financing.

3.5 Istisna

It is used in financing goods that are not yet ready for sale and will have to be manufactured. Example includes tailoring services, architect services etc. It is an order to producer to manufacture a specific commodity for the purchaser. It is used in pre-shipment exports financing and usable in all other situations where goods have to be manufactured before sale.

4. Liabilities: Deposits

Liabilities are the deposits placed with the bank. The two main categories of deposits are checking accounts and non-checking accounts. Some accounts are remunerative and some are non-remunerative. In the following lines, the deposit products offered by Islamic Banks are discussed below:

4.1 Non-Remunerative Accounts

Current Account is an example of a Non-remunerative checking account. The money deposited in such account is considered ‘Qard’ (Non-interest bearing loan). The money is invested in the fund by the bank. Bank utilizes the money to invest in Ijarah, Murabaha, Diminishing Musharakah, Salam, Istisna etc. The money is payable on demand.

4.2 Remunerative Accounts

Remunerative accounts can be checking i.e. Savings Account or non-checking accounts i.e. Term Deposits. The money is invested in the fund. The bank acts as ‘Mudarib’ i.e. *'Fund Manager'* and the customer acts as ‘Rabb-ul-maal’ i.e. *'investor'*.

The money is only invested in Shariah compliant assets. Bank utilizes the money to invest in Ijarah, Murabaha, Diminishing Musharakah, Salam, Istisna etc. The Weightage is assigned to each category of investment that is stated to the customer at the outset. Profit is declared at the start of the month for the previous month based on the weightage previously announced. Profit is paid out of the actual Gross Income.

The profit is distributed as follows:

Category	Deposit (Rs.)	Weightage	Weighted Average	Profit	Rate*
Savings	3,000	0.1	300	57	1.89%
1 Month	1,000	0.3	300	57	5.66%
3 Months	3,000	0.5	1,500	283	9.43%
6 Months	6,000	0.6	3,600	679	11.32%
1 year	7,000	0.7	4,900	924	13.21%
Total	20,0000		10,600	2,000	

Profit = $\frac{Wt.AvgInvestment}{TotalWt.AvgInvestment} x TotalIncome$

Profit Rate = $\frac{\text{Pr}ofit}{Investment} x100$

In last few years, Islamic finance industry experts have developed Shariah Compliant instruments

for managing liquidity. Some of them are as follows:

a. Bai Salam in Bill Discounting.

b. Murabaha in Usance Bill Discounting.

c. Running Musharakah.

d. Tijara for Short Term Liquidity Management.

e. Treasury Financing/Investments by way of Pool Management mechanism.

f. Treasury Investments/Financings by way of Short Term Investment through Commodity Murabaha using Tawarruq.

g. Shariah Compliant Asset Backed Securitization like Sukuks.

h. Development of Islamic Benchmark i.e. IIBOR and Islamic T-Bill is underway which will deepen and integrate the financial markets comprising Islamic Financial Institutions.

Islamic Finance is catering to the needs of all investors. Islamic finance apart from being Shariah Compliant also has ample potential to attract investors solely from the business point of view as well. Islamic Finance is growing in multiple dimensions and is now spreading in other financial sectors like insurance, structured finance, project finance, mutual funds, syndicated finance, investment banking etc.

Islamic Finance is now able to provide one stop solution to its customers. Shariah compliance also ensures Corporate Social Responsibility (CSR) and ethical compliance. Islamic banks do not conduct business with companies producing tobacco, alcohol or engaged in business of gambling, casino, nightclubs, prostitution etc. This mechanism has given Islamic banking the name of ‘ethical banking’ in Europe.

Islamic Investments are not involved in Risk Arbitrage, Junk Bonds, Muni Bonds, Brady Bonds, Currency Options, Swaption, Swaps, Call/Put Options, Combinations or spreads of Options, Futures trading, Forward contracts, Credit Default Swaps, short selling, speculative insurance underwriting, sub prime loans, debt swaps, rollover loans, CDOs, excessive leveraging etc.

Islamic investments are more akin to equity financing. The balance sheet of Islamic banks is capable of taking financial shocks. Islamic banks are not obliged to give fixed return to their depositors and general creditors. The creditors, shareholders and depositors share and

participate in the bank's business. Therefore, if incase, there is a shock on asset side (NPL increasing), Islamic banks will be able to share this loss with their depositors and shareholders.

Islamic banks can not rollover loans. Therefore, the packaging and repackaging of loans and then issuing more and more debt securities on the back of these non performing loans can not legally happen in Islamic Banks. Islamic banks are obliged to have backing of assets in all their investments. Therefore, Islamic banks losses even theoretically can not go beyond the value of the real asset.

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