Islamic Finance: Complement or alternative

STUDENT'S NAME: ZOUHAIR KASTITE

TUTOR'S NAME: JUAN ANGEL LAFUENTE LUENGO

BACHELOR'S IN FINANCE & ACCOUNTABILITY

COURSE 2017/2018

Abstract

The present work intends to analyse if the Islamic Bank is an alternative or complementary approach to the traditional Banks and the challenges that lie ahead. First, we will make an approximation to the current situation of Islamic finance in order to describe the Islamic finance history and what are its fundamental principles. Then we will present the different financial instruments that meet those principles, to finally address the challenges and opportunities that Islamic Finance represents.

Keywords

Islamic banking, interest, finance, Islam, *Shari'ah*, finance ethics, Islamic finance, usury

Index

<u>Index of Figures</u>

Introduction

The central theme of this project is about Islamic finance as a global financial phenomenon on the rise. It is about highlighting the global context of Islamic finance and its fundamentals since the development of Islamic finance in the last two decades is one of the most interesting developments in the recent history of the global financial services industry. It aims to align financial practices with what *Shari'ah* establishes in order to meet the financing needs of some investors that reject "conventional" financing. In addition to that, the Islamic banking system is gaining credibility through the important role it is playing in the development of several Gulf countries and is increasingly acceptance in international markets.

Therefore, the main objective of this paper is to answer the question of whether they constitute an alternative or a complement to the current financial sector by analyzing the restrictions and challenges facing Islamic banking.

So, to answer the initial question, two essential blocks will be dealt with; On the one hand, an approach to Islamic finance will be made to know its nature and main characteristics. On the other hand, the displayed data will be used to analyze the main challenges facing Islamic finance and we will proceed to give a reflexive response to the central question of this paper.

Chapter 1

Approximation

The Islamic finance industry represents a segment with great growth. It is a well-established industry in the Persian Gulf countries, since these economies have enjoyed of large surplus capital due to the increasing oil price. Islamic financing is well dominant is some countries, like Malaysia. The first European Islamic bank, the Islamic Bank of Britain, started operating in 2004.

Islamic finance has known a remarkable development for the last 30 years. The development of oil prices has been an effective accelerator since it pushed the oil producing countries to invest the surpluses. The events that have taken place in financial markets around the world have not prevented the industry from continuing to grow in volume of assets, although at a more moderate pace than before.

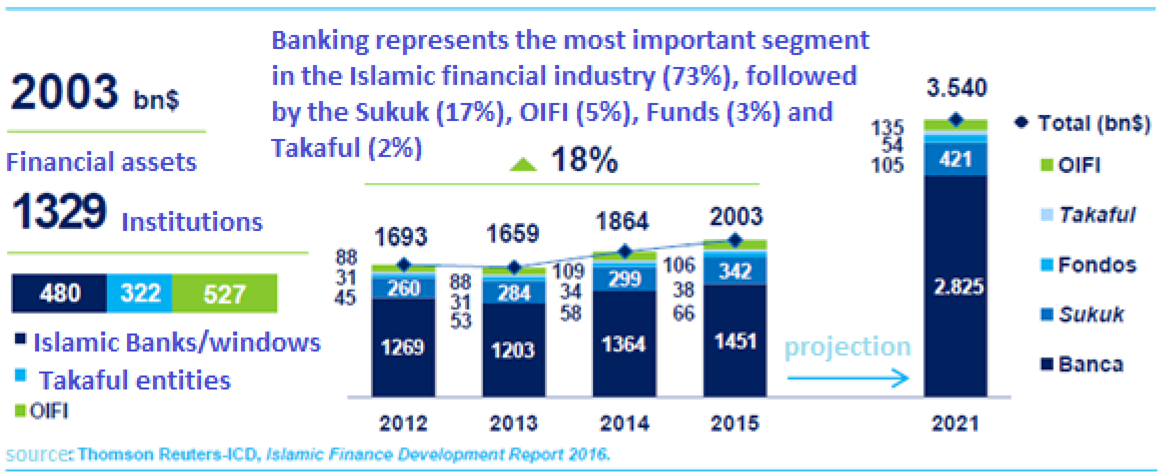

Figure 1 Islamic finance development Source: (Bensar, 2017)

In last years, Islamic financing has grown at a rate of 18%. Banking represents 73% of the Islamic financial industry, followed by the Sukuk with 17%, Other financial institutions (OFI) 5%, funds 3%, Takaful 2% (Bensar, 2017).

The Islamic law prohibits paying and receiving interest, but not making money. The Islamic system encourages all parts of a financial operation to share risks, gains and losses.

The Islamic finance goal is to establish a bond between performance, productivity and project quality, to ensure a more equitable redistribution of income and wealth.

For Aristotle, the economy must allow to reach wealth. Understanding wealth as the abundance of goods and their usefulness, not as a sterile and dishonourable accumulation of capital that qualifies usury. This vision offered by Islam, as well as in the Franciscans since the beginning of the 13th century, reflects a conception of, what we nowadays call, ethical economy.

Islamic finance may be considered as part of ethical finance, since they are characterized by a moral and socially responsible dimension (Guéranger, 2009).

The principles of Islamic finance connect with some of the 17 sustainable development goals established by the UN (Standard & Poor's, 2016), as we can see in Figure 2.

Figure 2 Islamic Finance Principles Source: (Standard & Poor's, 2016)

Definition

Islamic finance refers providing financial services in accordance with the Islamic law or jurisprudence (*Shari'ah*). Unlike legal systems, that are limited to the secular aspects of everyday life, *Shari'ah* does not distinguish between religious and other aspects of society, including transactions located in the political, economic or social sphere. The Islamic conception does not support all social activities and prohibits, for moral and ethical reasons, the activities related to drugs, pork based products, gambling and non-monetary assets, speculation, among other activities.

According to Benali, the Islamic economy "seeks economic progress to preserve Muslim morals and values; its characteristics differ from the conventional economy, because it's based on the prohibition of all types of interest and speculation, on the *Zakat* tax, which is the basis of the Islamic fiscal policy, consisting in paying annually 2.5% of one's patrimony and wealth. He also says that "it covers a wide range of issues, such as property rights, the commission system and the resources administration, as social justice and good management of the wealth redistribution are the two main foundations of the global Islamic economy "(2017: 38).

As numerous works show, Islamic finance is making its way into the global Islamic economy along with other economic sectors such as tourism, food, clothing, communication, pharmaceutical industry, etc. In Figure 3 we can see the different sectors that make up the Islamic economy.

Sector	**Expenditure in $1 billion (2014)**	**Features**
Islamic finance	1814 (1.27% of the world financial market)	Islamic financial products that meet the *Shari'ah*
Halal Food	1128 (17% of the global market)	Food and meals with certificate *Halal*, that fulfill the requirements of the *Shari'ah*
Halal Tourism	142 (11% of the world market)	All tourism services that comply the *Shari'ah*, hotels that offer *Halal* food or Prayer Services

Pharmaceutical industry	75 (7% of the world market)	*Halal* Pharmaceuticals
Cosmetics industry	54 (7% of the world market)	*Halal* Products Cosmetics
Clothing and fashion	230 (11% of the world market)	Personalized Clothing
Media and Leisure	179 (5% of the world market)	All media products offering Islamic religion-related products: Quran related TV, Islamic education TV, arab and islamic culture
Total	3622	All the economic products and services that comply with the *Shari'ah*

Figure 3 Islamic Economy Source: (Benali, 2017)

History of Islamic finance

Islamic finances came to light in the late seventh century, although the development of modern Islamic finance dates back to the nineteenth century. Due to this, in this work we will focus on its definition since the nineteenth century

The development followed to implement a *Shari'ah* compatible economy, can be divided into three phases, according to Iqbal & Mirakhor (2011).

Phase I: before 1960

Throughout the 19th century and part of the 20th century, several Muslim countries were under colonial rule. During this colonial period, these societies lost contact with their old traditions, values and cultural heritages.

After the end of the colonial period, Muslims began to rediscover their identities and manifested their desire to recover the values lost during colonialism, especially in the economic sphere.

Criticism and opposition to the interest began in Egypt in the late nineteenth century when Barclays Bank was established in Cairo to raise funds for the construction of the Suez Canal, and began collecting interest, a matter considered usurious and punishable by the Islamic law (*Shari'ah*).

In the 1890s, a community of Muslims in South India took the first step towards their desire to follow an Islamic model of economic activities through the establishment of interest-free loans. Basically, it was an association that collected donations to provide loans without interest to the poor.

During the first half of the 20th century there were several attempts to highlight the areas in which the conventional economic system conflicted with Islamic values. The need of an alternative economic system conforming to the principles of Islam soon came to the fore and economists began to explore *Shari'ah* compliant contracts.

By 1953, Islamic economists had offered the first description of an interest-free bank on a two-tier *Mudarabah* and *Wakala* (agency) basis. By the end of the 1950s, Islamic economists had begun to offer theoretical models of financial intermediation as a substitute to interest-based banking.

Phase II: 1960s - 1980s

By the start of the 1960s, the demand for *Shari'ah*-compliant banking was such that it resulted in the establishment of the Mit Gbamr Local Savings Bank in Egypt in 1963 by the noted social activist Ahmad al-Najjar. This is widely considered to be the first modern Islamic bank (Iqbal & Mirakhor, 2011).

It is worth noting that Dr. Najjar chose to promote this institution as a social welfare institution rather than as an Islamic bank. His bank, based on the principle of rural banking within the general framework of Islamic values, lasted just four years.

Around the same time, there were parallel efforts in Malaysia to develop a scheme that would enable Muslims to save money to perform the Pilgrimage without the contamination of interest that regular commercial banks were charging. The Pilgrims' Savings Corporation was later incorporated into the Pilgrims' Management and Fund Board.

The Nasir Social Bank in Egypt, established by presidential decree in 1971, was the first state-sponsored interest-free institution. The establishment of the Dubai Islamic Bank in the UAE in 1975 is considered to be one of the earliest private initiatives (Iqbal & Mirakhor, 2011).

The accumulation of revenues in several oil-rich Muslim countries in the Middle East in the 1970s offered strong incentives for creating suitable investment outlets for Muslims wanting to comply with the *Shari'ah*. This business opportunity was exploited by both domestic and international bankers, including some of the leading conventional banks.

In 1975, the Islamic Development Bank (IDB) was established, in Jeddah, on the lines of regional development institutions with the objective of promoting economic development in Muslim countries as well as offering *Shari'ah* compliant development finance. The institution has played a key role in expanding Islamic modes of financing and in undertaking valuable research in the area of Islamic economics, finance and banking. The first specialized research institution, the Centre for Research in Islamic Economics, was established at the King Abdul Aziz University of Jeddah, Saudi Arabia, in 1978.

In 1975, the Islamic Development Bank (IDB) was established on the lines of regional development institutions with the objective of promoting economic development in Muslim countries as well as offering *Shari'ah* compliant development finance. The Jeddah-based IDB has played a key role in expanding Islamic modes of financing and in undertaking valuable research in the area of Islamic economics, finance and banking. During the 1970s, the concept of a financial *Murabahah* (trust financing) was developed as the core mechanism for the placement of Islamic banks' funds. Academic and research activities were launched with the First International Conference on Islamic Economics, held in Mecca, Saudi Arabia, in 1976. The first specialized research institution, the Centre for Research in Islamic Economics, was established at the King Abdul Aziz University of Jeddah, Saudi Arabia, in 1978.

The 1980s marked the beginning of a trend of rapid growth and expansion for the emerging Islamic financial services industry that continued through the 1990s. During that period, the International Monetary Fund (IMF) initiated research in the macroeconomic implications of an economic system operating without the basis of interest, but on a system based on the sharing of profit and loss.

During the early stages of the Islamic financial market, Islamic banks faced a dearth of quality investment opportunities, which created business opportunities for the conventional Western banks to act as intermediaries to deploy Islamic banks' funds in accordance with guidelines provided by the Islamic banks. Gradually, Western banks realized the importance of the emerging Islamic financial markets and began to offer their own Islamic products through "Islamic windows" in an attempt to attract the clients directly.

Phase III: 1990s-present day

By the early 1990s, the market had gained enough momentum to attract the attention of policymakers and institutions interested in introducing innovative products. Recognizing the need for standards, a self-regulatory agency — the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) — was established, recognized and adopted by several countries.

However, with the growth of the market, the regulatory and supervisory authorities, with the help of the IMF and the World Bank that had already made some contributions to the field through research and investigation, established a dedicated regulatory agency, the Islamic Financial Services Board (IFSB) to address systemic stability and various governance and regulatory issues relating to the industry.

During the equities market boom of the 1990s, several equity funds based on *Shari'ah*-compatible stocks emerged. The Dow Jones and Financial Times launched Islamic indices to track the performance of Islamic equity funds. The number of conventional banks offering Islamic windows grew.

Citibank was one of the early Western banks to establish a separate Islamic bank — Citi Islamic Investment Bank (Bahrain) in 1996 — and the Hong Kong and Shanghai Banking Corporation (HSBC) now has a well-established network of banks in the Muslim world. With the objective of promoting Islamic asset securitization and private equity and banking in OECD countries.

HSBC Global Islamic Finance (GIF) was launched in 1998. The list of Western banks keeping Islamic windows includes the American Express Bank Ltd., ANZ Grindlays, BNP-Paribas, Deutsche Bank UBS, and Kleinwort Benson. The leading non-Western banks with significant Islamic windows are National Commercial Bank of Saudi Arabia, United Bank of Kuwait, and Riyadh Bank (Iqbal & Mirakhor, 2011).

Several institutions were established to create and support a robust financial system. These institutions include the International Islamic Financial Market (IIFM), the International Islamic Rating Agency (IIRA), the General Council of Islamic Banks and Financial Institutions (CIBAFI) and the Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI).

Islamic finance has begun to go global. Although Western financial centers and financial intermediaries have always played an important part in executing and innovating Islamic transactions, such activities have been mostly carried in the private sector and in a discreet fashion.

By early 2000, several non-Muslim countries taking an interest in this emerging financial market. Islamic finance has had a long, if silent, presence in Europe. A major early development was the establishment in 1981 of the *Dar Al-Maal Al-Islami* Trust in Geneva, an investment company that held stakes in several Islamic banks. The UBS of Switzerland is the leading provider of *Shari'ah*-compliant wealth-management services.

Nowadays, London's historical reputation and significance as a financial center, has made it a popular choice for Islamic financial transactions. In 2008, the European Finance House (EFH), a unit of Qatar Islamic Bank, was awarded a banking license in the UK to provide Shari'ah-compliant banking.

As more steps are taken to develop London as a hub for Islamic finance, it poses serious threats for regional financial centers such as Bahrain and Malaysia.

Pre-1950s	Barclays Bank opens its Cairo branch in the 1890s to process the financial transactions related to the construction of the Suez Canal. Islamic scholars challenge the operations of the bank, considering its dealings to involve interest. This critique also spreads to other Arab regions, and to the Indian sub-continent where there was a sizeable Muslim community. Majority of *Shari'ah* scholars declare that interest in all its forms amounts to the prohibited element of *riba*.
1950s–60s	Initial theoretical work in Islamic economics begins. In 1953, Islamic economists offer the first description of an interest-free bank based either on two-tier *mudaraba* or *wakala*. Mit Ghamr Bank in Egypt and Pilgrimage Fund in Malaysia start.
1970s	First Islamic commercial bank, Dubai Islamic Bank, opens in 1974. Islamic Development Bank (IDB) is established in 1975. Accumulation of oil revenues and petro-dollars increases demand for *Shari'ah*-compliant products.
The 1980s	Islamization of economies in Islamic Republics of Iran, Pakistan and Sudan, which introduce interest-free banking systems. Increased demand attracts Western intermediation and institutions. The IDB establishes the Islamic Research and Training Institute (IRTI) in 1981. Countries like Bahrain and Malaysia promote Islamic banking parallel to the conventional banking system.
The 1990s	Attention is paid to the need for accounting standards and regulatory framework. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is established. Islamic insurance (*takaful*) is introduced. Islamic Equity Funds are established. Dow Jones Islamic Index and FTSE Index of *Shari'ah*-compatible stocks are developed.
2000–Present	The Islamic Financial Services Board (IFSB) is established to deal with regulatory, supervisory and corporate-governance issues. *Sukuks* (Islamic bonds) are launched. Globalization of Islamic finance as *Shari'ah*-compliant transaction starts to appear in Europe, Asia and North America. Growth of academic interest and research followed by offering of organized programs at reputable Western universities. Limited application of financial engineering through introduction of profit-rate swaps. Legal issues are raised in cross-border jurisdictions after defaults on *Shari'ah*-compliant transactions during and after the financial crisis.

Sources: Khan (1996), IDB (2005), and Iqbal and Mirakhor (2007).

Figure 4 Developments in modern Islamic economics and finance Source: (Iqbal & Mirakhor, 2011)

Fundamental principles of Islamic finance

The main sources of Islamic law can be divided into two:

• Islamic law (*Shari'ah*), which emanates from the Qur'an. It's a text that addresses all the behaviors of the believer's life. It is not only a code of religious beliefs and obligations and a code of conduct, but it is also a commercial code (Corróns & Torre, 1999).

• The Sunna, which is a compilation of the traditions established from the behaviour of the prophet Mohamed and his words (*Hadits*), collected by his companions.

These primary sources must be interpreted, because they do not respond to all situations that a Muslim has to face. Thus, a secondary source is born, composed by the *Fiqh* (Islamic jurisprudence) that is based on the interpretations of concrete cases.

According to François Gueranger, among the essential concepts of Muslim law that emerge from the Shari'ah and that permeate all Islamic business law, there are four fundamental notions that are the basis of Islamic finance (Guéranger, 2009: 34):

- *Riba*[1], which is the capital sin in the Islamic law. It's related to the interest, although it is a much broader concept that is not limited to interest only, but to any provision of money or fungible from one person to another that generates a benefit to one of them without compensation. The interest consists of receiving remuneration only because some money has been made available to a third party. The *Riba*, generally, is the prohibition of profit without an effort or responsibility and the loan of money with interest is a part of this prohibition. In the Qur'an, you can find several verses that prohibit usury (*Riba*) as for example, verses 275, 276 and 278 (Junior, 2014).

- *Gharar,* evokes the uncertainty resulting from information voluntarily or involuntarily insufficient, imperfect or asymmetric in economic transactions. Uncertainty is linked to speculation, which consists of predicting the outcome of an event. This generates a situation of ignorance regarding the gains or losses

[1] Its literal meaning is increase.

of the two contractual parties, capable of causing damage to one or the other, since they cannot know, from the beginning, whether the contract is balanced or not. Under Islamic law, a contract cannot harm either party and therefore all commercial operations and contracts that favour the strongest of the contracting parties are prohibited (Corróns & Torre, 1999).

- *Haram,* is the prohibition of any illicit activity. The prohibition distinguishes between the activity itself and the object of the activity. Objects and activities catalogued as Haram cannot be subject to transactions.

According to Corróns and Torre to understand the previous concepts, it is important to take into account the special character of four Islamic concepts (Corróns & Torre, 1999; 25):

• Justice: the Islamic ideal of justice requires the sharing of the losses, profits and benefits of all economic activity carried out jointly. It is not considered fair for the lender to increase his profits without facing a risk or productive effort.

• Ownership: any loan is considered a transfer of property rights, claimable only by the same amount originally represented.

• Money: it is considered an instrument and not a deposit of value.

• Unit: a conception different from the western one. It makes every member of the community responsible for the attainment of Islamic purposes and the welfare of the community. This unity is the origin of the moral obligation to make use of money oriented to common welfare.

According to different authors, these principles emanates from the *Shari'ah* or Islamic law:

• Sharing both profits and losses in financial operations.
• Prohibition of any payment above of the real main amount
• Linkage to the real economy, therefore, behind each financial product there must be an underlying asset that justifies the financial instrument itself.
• Prohibition of speculative activities.

Islamic finance products. Financial instruments

The term loan, in Islamic finance, refers only to a benevolent loan (*Qard al Hasan*). A form of financial assistance to the needy that will be reimbursed without surcharge, the other instruments are called financing modes (Hussain, et al., 2015)

According to Hussain, Shahmoradi and Turk (cited in, Kammer, et al., 2015), those instruments are based on contracts and can be classified into the following categories:

Profit and Loss Sharing (PLS)

This category is closest to the spirit of Islamic finance. Its basic principles of equity and participation, as well as its strong link with the reality of economic activities, help to promote a more equitable distribution of income and therefore a better assignation of resources.

There are two types of PLS financing:

Musharakah: It's a partnership to share profits and losses and the most authentic form of Islamic financing[2]. It is a joint venture contract where two or more partners provide capital to finance a project or movable or immovable property, either permanently or gradually[3]. The members of the *Musharaka* have the right to participate in the management. However, while profits are distributed according to previously agreed ratios, losses are shared in proportion to the contribution to capital.

Mudarabah**:** It's a contract in which one party provides financing (*rabb al mal*) and the other provides effort and management experience (*mudarib*), in order to generate a profit. The participation in the benefits is determined by mutual agreement, but the eventual losses, are assumed by the financier, except if they are the result of negligence, misconduct or breach of the contractual terms of the *mudarib*. Sometimes, the mudarib directs the business and the financier cannot interfere in the management, although conditions can be specified to guarantee an optimal management of the capital.

[2] It can be limited (*Shirkat al-inan*) or unlimited (*Mufawadah*).
[3] The decrease of *Musharaka* (*Musharaka Mutanaqisa*) is mainly used for financing real estate: A partner promises to buy the other party's participation gradually until the title of ownership is fully transferred to the buyer partner.

Islamic banks mainly use *mudaraba* to raise funds, these contracts are also used for mutual funds management.

Non PLS contracts

These types of contracts are the most common in practice. They are generally used to finance consumer and corporate loans, as well as the assets rental or manufacturing[4]. The instruments included are:

Murabahah: It is a sales operation used mainly in commerce and financial assets[5]. The bank buys the goods and delivers them to the customer, deferring the payment to a date agreed on by the two parties. The expected return on the Murabahah is normally aligned with conventional loan interest payments, creating a similarity between *Murabahah*'s sale and asset-backed loans. However, the *Murabahah* is a transaction where the intention is to facilitate the acquisition of goods and not to exchange money for more money over a period of time. Unlike conventional loans, after the *Murabahah* contract is signed, the amount being financed cannot be increased, in case of late payment or default, a fine cannot be imposed, unless the buyer deliberately refuses to make the payment. In addition, the seller must assume any responsibility for the delivery of defective products. *Murabahah* transactions are widely used to finance trade, as well as for interbank financing and liquidity management through a multi-step transaction system known as *tawarruq*[6].

Ijara: It's a sales contract of the right to use an asset for a period of time. It is essentially a lease, by which the lessor must own the leased asset during the entire lease term. Since the good remains property of the lessor, the asset can be seized in case of non-payment by the tenant. However, the landlord is also responsible for the maintenance of the assets, unless the damage is due to the negligence of the tenant. Another variety of *Ijara* takes the form of a rent with option to purchase at the end of the lease, for the residual price of the predetermined asset. This is done by a second contract independent of the lease[7].

[4] These products comply with *Shari'ah*, are similar to conventional contracts based on sales margin and lease contracts.
[5] The majority of Islamic funding adopts this form (Demirgüc-Kunt, Klapper, y Randall, 2013, quoted in, Hussain, et al., 2015).
[6] In some juridictions, the Tawarruq transaction is not considered obedient to the principles of *Shari'ah* (Hussain, et al., 2015).
[7] This is easily understood because of its similarity to conventional financing (installment sales and/or leasing).

Salam: It is a form of early agreement where delivery occurs at a future date in exchange for prompt payment. Such transactions were originally allowed to meet the financing needs of small farmers since they couldn't obtain good returns until several periods after the initial investment. An important condition for the validity of a *Salam* is the payment of the price in full at the time of initiating the contract. The subject, price, quantity, date and place of delivery must be specified with precision in the contract. In case the seller cannot produce the goods, nor obtain them elsewhere, the buyer can recover the amounts paid without increases or waiting until the goods are made available. If one of the parties fails to comply with the contract, the bank recovers the initial investment, but will have to accept the loss of benefit.[8]

Istisna: It's a contract in which a product can be negotiated before it comes into existence. The unique feature of *istisna* is that nothing is exchanged on the spot nor at the time of hire. Maybe, it's the only forward contract in which the obligations of both parties are located at a future time. In theory, the *istisna* contract could be made directly between the end user and the manufacturer, but it's generally a three-part contract, where the bank acts as an intermediary. Under the first *istisna* contract, the bank agrees to receive payments from the client in a long-term plan, while in the second contract, the bank (as buyer) makes progressive payments to the product in a shorter period of time[9].

<u>Fees based products</u>

The fees services provided by Islamic banks include bank transfers, issuing letters of credit and guarantees, credit cards and recollection and safe custody services, mainly used in trade financing. Usually, they are supporting services of the *Murabahah* and *Mudarabah* transactions.
The most used contracts on this type are the following:

---

[8] *Salam* and *Istisna* are debt-based Islamic financing instruments that are not frequently used and do not meet the physical possession status of the asset for sale

[9] There are four major differences between the *Istisna* and *Salam* contrasts. (i) *istisna* implies the sale of manufactured products unlike *Salam* that can be used in standardized products; (ii) Unlike *Salam*, which requires full price payment in advance, *Istisna* allows for timely, deferred payments or even installment payments; (iii) A *istisna* contracts may be cancelled unilaterally until the date on which the manufacturer begins to work on the contract; and (iv) the delivery time is fixed in *Salam*, while *istisna* may specify a maximum time for delivery after which the buyer is no longer obliged to accept the goods (Hussain, et al., 2015).

Wakalah: It results from the bank acting as agent of a client in an exchange or transaction or issuance of a letter of credit. In *Wakalah* based commercial financing, the client goes to the bank to act as his agent and to provide him with letter of credit. The bank requires the client to place the total amount of the goods to be purchased in a *wadia* or deposit account. Afterwards, the bank makes the payment to the counterpart bank and the pertinent documents are delivered to the client, who pays a fee or commission under the principle of agency commission or *ujr*.

Kafalah: It is a financial guarantee by which the bank delivers a pledge to a creditor on behalf of the debtor to cover fines or any other liability. It is widely used together with other financing methods or documentary credits.

Ju'ala: It is essentially an *Istisna* contract that is applicable to provide a specific service opposing to manufacturing a product.

<u>Sukuk (Islamic Bonds)</u>

The *Sukuk* or Islamic bonds are one of the most known and important products. They are financial instruments (financial assets) that can be traded in the markets, they are perceived as similar to the backed assets (ABS) (Ruiz, 2009).

This issuance must have a real asset as collateral, and it grants the possessor the property of the asset, along with the benefit and risk of the property (Benali, 2017) and are highly appreciated by investors who generally have a different behaviour than of the usual bond buyers. Investors acquire them with the intention of maintaining them until maturity (Ruiz, 2009).

These are some types of Sukuk:

- On sale basis through contracts (*Sukuk Al-Murabahah*, *Sukuk Al-Salam, Sukuk Istisna 'a*).
- Sharing profits and losses of the business (*Sukuk Al-Mudarabah*, *Sukuk Al-Musharaka*)
- Lease contracts (*Sukuk Al-Ijara*)

Takaful (Islamic insurance)

It is an insurance contract that meets the *Shari'ah*. Usually conventional contracts don't comply with the *Shari'ah* because of its similarity to the games of chance. Its main characteristics are the prohibition of *Gharar* (uncertainty), *Maysir* (Speculation) and *Riba* (Interest) (Benali, 2017).

The term *Takaful* comes from the word *Kafala*, which means guarantee, and, therefore, *Takaful* means joint guarantee (Benali, 2017). It is a concept of insurance based on cooperation, protection and mutual help among the participants through the sharing of a risk with sum contribution in order to constitute a fund.

According to Fouad Benali's doctoral thesis, the insurance is based on the following fundamental principles:

• Mutual responsibility
• The cooperation
• The protection of each other against any kind of difficulties, or disasters.
• The insured cooperate with each for the common good
• Losses and responsibilities are shared

In the event that the invested contributions generate benefits, this is shared among the participants in the fund, similarly, in case of losses, they are assumed by the participants, as indicated above, this is one of the fundamental principles.

Islamic banking in everyday life

Once the description of the fundamental principles of Islamic finance and the financial instruments of the sector has been done, we will now address how Islamic banks operate in everyday life since they are considered a fundamental part of Islamic financing. The prohibition of the mechanism of interest and the resort to certain fields of activity and the assimilation of all the fundamental principles of Islamic finance is what mainly oppose conventional banks to Islamic banks.

Therefore, we must not lose sight of the fact that an Islamic bank is similar to a conventional bank, that is, it offers the same services, it has windows and agencies and it’s open to a broad public, or simply, to all the world. Although some differences exist, for example, conventional banks guarantee capital and profitability, Islamic banks cannot guarantee any fixed profitability index, nor can they guarantee the capital because of the principles which they are directed by. They share losses and profits.

In the following illustration, we can observe the differences between deposits in an Islamic bank and a conventional one

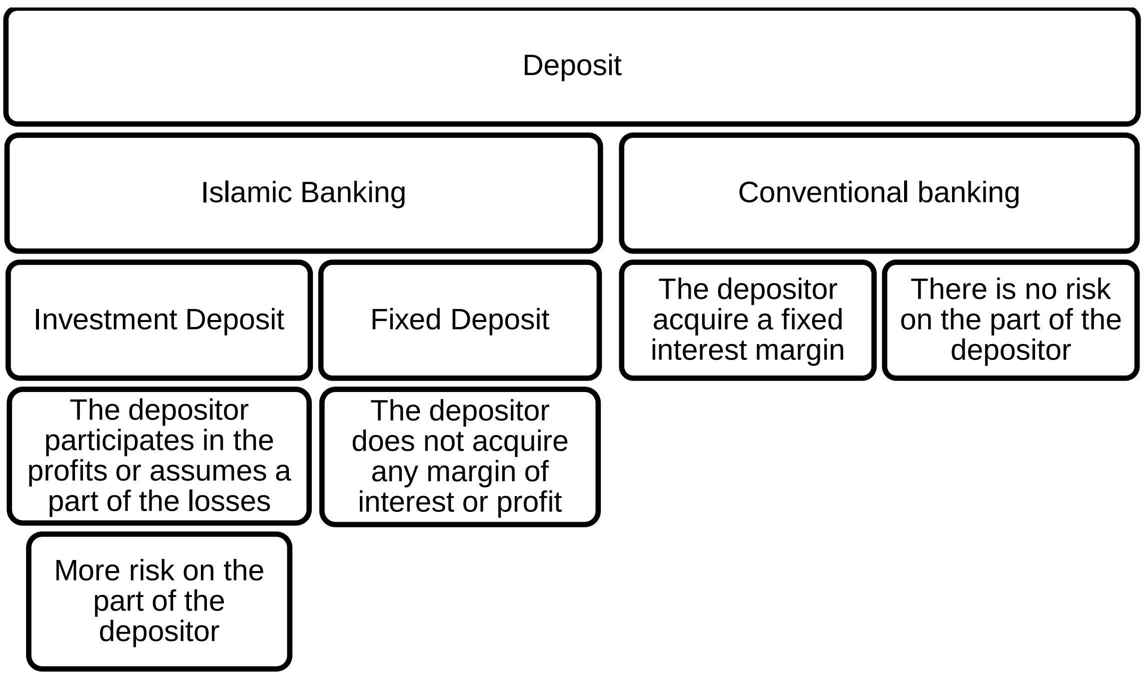

Figure 5 Differences between deposits in an Islamic and a conventional Bank Source: (Abuamria, 2006)

The administrative management of Islamic banks is identical to the conventional banks, which means that several positions or departments are equal, such as the general assembly, the boards of directors, financial and administrative departments, as well as being subject to the control of the Central Bank of the country where they are located. Islamic banks also have a department that exercises control over financial products, known as the *Shari'ah* Council that ensures that the products meet the standards by issuing *fatwas*[10], that is, their opinion as to whether the new products meet the principles of *Shari'ah* or not and is the most relevant department of Islamic banks. In addition, the existence of this council is one of the essential requirements to be admitted as an Islamic bank in the IAIB (Abuamria, 2006).

These councils are formed by specialized jurists and their reputation increases the value of the legal opinions that they emit, being able to collaborate in the growth of the bank and the products that it offers.(Guéranger, 2009).

The structure of the balance sheet is a little different from the balances of conventional banks. The liabilities of an Islamic bank are composed by different categories of deposits. On the one hand, the deposits constituted by the clients and deposited in the banks to be managed (*Mudarabah* and *Wakala*) that are not guaranteed in exchange for sharing the losses and benefits. On the other hand, guaranteed deposits that do not provide any type of compensation composed of unpaid current accounts (*wadia Jariya*), savings accounts and investment accounts.

As assets, we find the participation of the bank in the companies that lead to a risk sharing and the financing credits of current assets. It also reflects long-term commercial services such as *Murabahah*, *Salam*, *Istisna* and investment in securities or real estate in order to sell them (Lotfi, 2017)

[10] The Arabic word *fatwa* in the technical language of *Shari'ah*, clarifies Islamic law by responding to one or more issues related to Islamic matters (Abuamria, 2006).

A simplified balance sheet of an Islamic bank may look like this:

Assets	**Liabilities**
Trade Financing (*Salam, Murabahah*)	Demand Deposits (*Amanah/Waad*)
Leasing / Rentals (*Ijarah / Istisnah'*)	Investment Accounts (*Mudarabah*)
Profit/Loss Sharing Investments (*Mudarabah*)	
Equity Investments (*Musharakah*)	Special Investment Accounts (*Mudarabah*)
Fee for Services	Capital Equity Reserves

Figure 6 Balance of an Islamic Bank Source: (Iqbal & Mirakhor, 2011)

Islamic finance in Europe

Europe is considered the fourth area with the largest Muslim population, making Europe one of the first markets for Islamic finance. The interest of the Islamic finance industry in the European has been boosted by the issuance of 200 million pounds of UK and Luxembourg sovereign debt through *Sukuk*. As well as by Germany, where a turkish Islamic bank is operating.

According to the publication "The Future of Banking and Islamic Finance" by Fouad Benali[11] in the ICE magazine, there is currently a project to create an Islamic bank in the Eurozone, based in Luxembourg, which will be gradually extended to the rest of European countries. This bank offers retail, corporate and private banking services (Benali, 2015).

The same author cited above, states from the illustration below, that the expansion of the Islamic financial industry in Europe is concentrated in the United Kingdom, this being the reference as mentioned previously, while Luxembourg and France are competing with the United Kingdom (Benali, 2015).

[11] Doctor in Business economics. Researcher in growth of Islamic banking and finance in Europe. Carlos V. Autonomous University of Madrid International Center.

The growth of the Islamic financial industry in Europe		
Country	Development of Islamic banking in Europe	Islamic and/or conventional banks with Islamic product windows
United Kingdom 23 Islamic Banks, 16 conventional banks with Islamic windows and 6 complete Islamic banks	The emergence of the Islamic financial institutions (banks) in the United Kingdom came as a result of the support and the facilities provided by the British authorities to the Islamic financial institutions to access the market through the promotion of the offer in this market. The expansion of Islamic finance in the UK began in the late 1970s: • 1978: The British Government authorizes the first Islamic financial institution to open a branch in London. It is the Islamic Banking International holding. • 1979: The British government authorizes the Islamic finance House to open another branch in London. • 1983-1993: the Albaraka Group (Leader Of Islamic banks in the world) began financial transactions with three branches in Birmingham and London; The bank began working with Gulf and Southeast Muslims residents in the UK; In 1991 the bank came to have about 12,000 customers to whom he offered Islamic products, multiplying their deposits by 7 between 1983 and 1991. In June 1993 the Albaraka group closed its branches on the because of the British financial crisis and the new fiscal reforms of the Government (Law of 1987) that affected the foreign financial institutions, but continued to operate as an investment company in Upper Brock Street in West London.	Complete Islamic Banks (6) - Bank of London and The Middle East (BLME) - European Islamic Investment Bank - Gatehouse Bank - Islamic Bank of Britain (IBB) - QIB UK - Abu Dhabi Islamic Bank Conventional banks with Islamic windows - ABC International Bank - Ahli United Bank - Barclays - BNP Paribas - Bristol & West - Citigroup - Deutsche Bank - Europe Arab Bank - IBJ International London - J Aron & Co. - Lloyds Banking Group - Royal Bank of Scotland - Standard Chertered

	• In 1997 the Islamic Bank Ahli United Bank Kuwait opens a branch in London and presents the first project of sale contracts (Al-Murabahah and al-Ijara) known as Almanzil by the Islamic community of UK. • In 2004 the first Islamic bank in Britain IBB (Islamic Banking of Britain) opens. • April 2006 Another Islamic bank opened, the European Islamic Investment Bank (EIIB) • In June 2007 Bank of London and The Middle East (BLME) started their services in London. • In 2008 Islamic Bank Gatehouse Bank GB opens • In 2008, the Islamic Bank of Qatar QIB opens a branch in London as the first stage of expansion in Europe The first conventional banks offering windows of Islamic products in the UK are: ANZ International, City Bank, Dresdner Klein WortBenson, HSBC and Standard chartered	- Ubs - United National Bank
Luxembourg 2 Islamic Banks	Following the development and growth of the Islamic banking in Britain, the Government of Luxembourg Began To support the Reception of foreign Islamic investments. Faisal Holding Luxembourg It was the first Islamic financial institution to establish itself in this country. Traditionally, Luxembourg has been an international bond trading center and the Europe leader in this field. It's objective is to become an important Centre for the Negotiation of international Islamic financial instruments.	- Faisal Holding Luxembourg - Eurisbank, Islamic Bank Europe
France	• In 2008, Christine Lagarde, Minister of Economy And French industry in the	Banks Islamic

2 Conventional Islamic and 2 banks With advantages Islamic	Sarkozy government, makes statements indicating France's intention to become the pole of Islamic finance in Europe. • In December 2009, the Directorate General of the French Treasury introduced a series of changes in fiscal regulation for Islamic financial products, such as *Sukuk* (bonds) and contracts of Sale (*Murabahah*). • La SGAM (*Société Générale Asset Managment*), in Collaboration with The Banque Français commerciale de l'ocean indien (BFCOI) offers two Chord Products With the principles of Islamic banking. • In the second semester of 2013, the French bank *Société Général* Advertise your plan to invest 1 Trillion of dollars in the emissions of *Sukuk* Malaysian	- Kuwait Finance House - Albaraka Islamic Bank BConventional Ancos with VentanillIslamic as Products - BNP Paribas - Société Général
Germany 1 Bank Conventional With Islamic windows	Islamic finances arrived in Germany In 2010 of the ManOr Deustche Bank, which opened in Frankfort Islamic windows, getting around 380,000 clients of Turkish origin.	-Deustche Bank (Islamic products)
Switzerland 2 Complete Islamic banks and 2 conventional banks with Islamic windows	The experience of Switzerland is considered one of the most important European experiences in West. Bank Faisal was the first Islamic financial institution in Switzerland, starting to offer its services in the 1980s. The success of the Swiss experience is due to the conjugation of the Islamic finances with the support of the central Swiss bank, and to the exceptional fiscal situation of the State	- Dar al-Mal al-IslamiTrust. Geneva - Faisal Finance (Switzerland) S. A Geneva - Safa Investment Service - Bank J. Safra Sarasin

Ireland 1 Conventional bank with Islamic windows	The Irish experience is a part of the success of the UK experience with Islamic finances. There are conventional Irish banks that have begun to offer Islamic products.	-MFAI (Jersey) Limited (formely Masrif Faisal Al-Islami)

Figure 7 Islamic Finance in Europe Source: (Benali, 2015)

In the case of Spain, the presence of Islamic financial industry is restricted to the field of education and outreach, with the creation of the Islamic Center of Economy and Finance in 2013 and Coophalal created in 2015 in Barcelona. Being still in the process of analyzing and exploring the opportunities offered by Islamic financial instruments such as *Sukuk*.

In Spain, the growth of the Muslim population can be a potential source for generating business at retail banking in order to meet the demand for Islamic financial products, as has been the case in the rest of the European countries.

Chapter 2

Islamic finance. Restrictions and challenges

One of the challenges faced by Islamic financing is the legal uncertainty that exists in its environment, since there may be some difficulties because of the coexistence between the Islamic laws and the national laws of the country where they are located.

Some European countries already started taking steps towards solving this challenge as France or Great Britain, the latter being the first country to take the initiative. A ruling by the London Court in 2004 has set the basis for dealing with Islamic financial and banking products. The Court considers that there is simply a juxtaposition of rights and requirements and that the parties have to demonstrate that their products comply with the principles of Islamic finance (Guéranger, 2009).

Another challenge facing Islamic finance is the limited range of products they offer and the limitation that applies to banks. The products offered may not be very attractive to investors or may be not much varied.

One of the root causes may be the risk that is associated to participation contracts, where the bank has to control the partner, to ensure that he makes the correct decisions or in the case of entrepreneurs, who are often reluctant to share their power with the banks. That is why many banks prefer to bet on products in which they only are intermediaries.

In line with the above, Islamic financial engineering has emerged with the aim of providing services and creating products that comply with the principles of economic viability and *Shari'ah*. According to Najia Lofti's doctoral thesis, despite the progress made in this line, the positioning is still below the existing demand, which increased after the financial crisis (Lotfi, 2017).

Another challenge lies in the performance offered to depositors and investors. The lack of historical data and statistical tools make it difficult to dispel the doubts about this. Also, the lack of aggregate data makes it difficult to compare products, as well as between banks in different countries or the volume of cross-border transactions. Although currently more and more reports are being issued in this regard.

The little regulation in the tax aspect, where many European countries do not have established yet the fiscal treatment that should be given to investments or returns of these, and the existent international regulatory framework is still not enough. Various measures have been taken in this direction, such as the creation of different entities such as the Islamic Financial Services Board (IFSB), with the cooperation of the International Monetary Fund, whose mission is to establish a specific regulatory framework for Islamic financial institutions on the basis of the recommendations made by the Basel Committee. Other institutions created are the International Islamic Finance Market (IIFM), with the aim of harmonizing practices, and the International Islamic Rating Agency (IIRA).

Another problem is the lack of expert personnel in the sector, the Islamic banks have generally hired experts from the conventional banking sector and now these are forced to create new products, since the products to which they were used to are prohibited by the *Shari'ah*, as efficient and with the same goals as conventional bank products.

To ensure a better growth and settlement of Islamic finance, Islamic financial institutions should bet heavily on the following lines of action:

- Optimizing the governance of banks by developing the banking, legal and accounting standards to acquire a solid and structured system, with an emphasis on the transparency of accounts and transactions. And the development of a regulatory framework that allows a sound supervision and regulation.
- Diversify operations to consolidate the Islamic financial system
- Invest in human capital by offering training, for both banks and funds, so that the growth of Islamic finance is harmonious, as well as for investors or applicants for funds, to facilitate understanding and access to these financial resources.

A complement or an alternative to current finances

In the beginning of Islamic finance, and Islamic banking in particular, operations were largely carried out through conventional banking system acting as financial intermediaries. They detected a demand for products that comply with the principles of the *Shari'ah*, so they opted for the opening of windows offering products that comply with Islamic law and to acquire the Middle East capital flow. At the end of 2013, there were around 410 Islamic banking institutions around the world, including the banking systems of Iran and Sudan, which are the only countries that only have Islamic banking as banking institutions (Hussain, Shahmoradi, & Turk, 2015).

Nowadays, conventional banks with Islamic windows coexist with banks considered as Islamic. There is great potential in the sector, due to the growth they have experienced during the last two decades, especially in Europe and not only in Asian countries or Muslim countries, although currently it is mainly concentrated in some countries.

According to the report Overview of the global Islamic finance industry published in 2017 by the Dubai Islamic Bank, 75% of global Islamic financial assets are held by Islamic banks and conventional banks through its Islamic windows. 60% of these assets are held by Islamic banks with full rights (Bank, 2017).

The same report states that a pure Islamic banking model remains the preferred option over a window model, therefore, the future of Islamic banking goes through the development of a completely segregated Islamic banking model instead of a dual banking model based on the hybridization of Islamic and conventional banking (Bank, 2017).

Conclusion

In conclusion, Islamic banking is an alternative to conventional banking, although in these moments of growth and consolidation, they are only complementary. They are an alternative due to the growing demand by societies for ethical banking, and the main distinctions are a stronger reference to the real economy, the influence of Islamic law and lost interest.

Islamic products, which are mostly similar to conventional products, which Islamic banks offer them to customers at higher costs, in order to survive without charging any interests, but only if consumers are religious or conscious of ethical issues and are willing to pay for it. In addition, they are more inefficient, although in countries where they are more developed they are more efficient than in the rest. This is one of the challenges mentioned above that Islamic finance in general, and Islamic banking in particular, faces.

For their settlement as a real alternative to conventional banks, financial institutions should not only focus on institutional investors, but also on retail banking, since many people do not know about Islamic banking, so they cannot make the decision to embrace it or not. This approach must be done through a great awareness-raising work to publicize the principles of Islamic banking beyond a purely religious vision, since Islamic finance aims to promote social justice and advocate for equal opportunities for the less fortunate groups. An industry focused on small and medium enterprises could promote the economic development of less developed countries by helping the economic empowerment of the most disadvantaged groups.

The objectives of socioeconomic justice and the equitable distribution of wealth distinguish the Islamic economic principles from the prevailing principles in the last decades and bring it closer to the principles of ethical banking. This trend of booming demand for ethical and the sustainable development goals of the United Nations can contribute to further growth in the industry as they share the objective of the creation of a more equitable financing system, as we mentioned at the beginning of this work.

Taken together, Islamic finance and ethical banking have many advantages if used correctly. They could also make the economy more stable and prevent a new financial crisis.

In theory, Islamic financial institutions are more resistant to economic shocks because of the prohibition of the *Gharar* (speculation) by the *Shari'ah*, so they do not participate in toxic products with excessive risk nor subprime. The Islamic financial institutions escaped the direct impact of the global financial crisis and were initially isolated from their losses.

Another reason why it is an alternative is its usefulness as a way to the inclusion of low-income population or underdeveloped countries, since these segments are not profitable for conventional banks, so they are not usually targeted to them.

According to Mª Carmen's paper "Islamic banking as a tool for financial inclusion", that focuses on financial exclusion in the Muslim world, concludes that Islamic banking is emerging as a financial inclusion tool, since that the first potential development factor in Islamic finance worldwide is its ability to increase financial inclusion. Another element of internal character is the relative growth of Muslim population and external character is the growing importance of ethics in organizations (Cruz, 2015).

Glossary of Arabic terms

Shari'ah: The corpus of Islamic law based on Divine guidance, as given by the Qur'an and the Sunnah, and embodies all aspects of the Islamic faith, including beliefs and practices

Istisna (short form for bay' al - istisna'): A contract whereby a manufacturer (contractor) agrees to produce (build) and deliver well - described products (or premises) at a given price on a given date in the future. The price need not be paid in advance and may be paid in instalments in step with the preferences of the parties, or partly at the front end and the balance later on, as agreed

Sunnah: The second - most important source of the Islamic faith after the Qur'an and refers to the Prophet's operationalization and explication of the rules prescribed by Allah in the Qur'an in words and action

Fatwa: Religious verdict by a jurist

Rabb al-Mal: Capital owner or financier

Tawarruq: Reverse murabahah. Buying an item on credit on a deferred - payment basis and then immediately reselling it for cash at discounted/prize to a third party

Wadia: Trust or safe keeping

Qur'an (also written as al - Qur'an): The Holy Book of Muslims, consisting of the revelations made by Allah to the Prophet Muhammad. Prescribes the rules of social and personal behaviour, compliance with which guarantees social solidarity, economic growth and development

Gharar: Literally, "deception, danger, risk, and excessive, unnecessary uncertainty (ambiguity)."

Haram: Prohibited

Murabahah: Sale at a specified profit margin

Musharaka: Partnership. Both partners participate in the management and the provision of capital and share in the profit and loss

Qard hasan: Loan extended without interest or any other compensation from the borrower

Riba: Literally, "increase," "addition" or "growth."

Salam is a forward financing transaction, where the financial institution pays in advance for buying specified assets

Takaful: An alternative to the contemporary insurance contract. A group of persons agree to share a certain risk (for example, damage by fi re) by collecting a specified sum from each. Any loss is met from the collected funds

Wakala: Contract of agency in which one person appoints someone else to perform a certain task on his behalf

Sukuk: Negotiable financial instruments

Zakat: Amount payable by a Muslim on his net worth as a part of his religious obligations to redeem the rights of others

Fiqh: Corpus of Islamic jurisprudence. In contrast to conventional law, fiqh covers all aspects of life—religious, political, social, commercial, and economic. Fiqh is based primarily on interpretations of the Qur'an and the sunnah and secondar- ily

Hadits (pl. ahadith): Oral tradition of the Prophet Muhammad (pbuh) has narrated by his companions

Mudarib: Investment manager

Musharakah mutanaqisah: "Diminishing partnership"

Wadia: Trust or safe keeping

Bibliography

Abuamria, F. M., 2006. *El mecanismo de funcionamiento de los bancos islámicos y su tamaño en los mercados financieros. Un estudio compartivo internacional de su eficiencia.* Granada: Universidad de Granada.

Benali, F., 2015. EL FUTURO DE LA BANCA Y LAS FINANZAS ISLÁMICAS EN EUROPA: OPORTUNIDADES Y RETOS. *INTERNACIONALIZACIÓN DE LA INVERSIÓN Y LA EMPRESA,* Noviembre-Diciembre (887), pp. 91-106.

Benali, F., 2017. *CRECIMIENTO DE LA BANCA Y LAS FINANZAS ISLÁMICAS EN EUROPA Y SUS ESTRATEGIAS DE EXPANSIÓN.* Madrid: Universidad Autónoma de Madrid.

Bensar, F. Z., 2017 . *Las finanzas islámicas en España 2017,* Madrid: SCIEF-Casa Árabe.

Corróns, A. V. L. & Torre, O. O. d. l., 1999. *La banca islámica sin intereses : elementos básicos.* Madrid: Agencia Española de Cooperación Internacional.

Guéranger, F., 2009. *Finance islamique. Une illustration de la finance éthique.* París : DUNOD.

Hussain, M., Shahmoradi, A. & Turk, R., 2015. *An Overview of Islamic Finance,* s.l.: IMF Working Papers.

Iqbal, Z. & Mirakhor, A., 2011. *An Introduction to Islamic Finance - Theory and Practice.* Segunda ed. Singapore: John Wiley & Sons (Asia) Pte. Ltd..

Júnior, A. A. G., 2014. LA ÉTICA EN LAS FINANZAS ISLÁMICAS. *Revista da Universidade Vale do Rio Verde, Três Corações,* 12(2), pp. 306-315.

Kammer, A. y otros, 2015. *Islamic Finance: Opportunities, Challenges, and Policy Options ,* s.l.: INTERNATIONAL MONETARY FUND .

Lotfi, N., 2017. *Aspectos de las finanzas islámicas: ingenieria, contabilidad y gestión de riesgos. Caso Práctico: España centro europeo de las finanzas islámicas.* Madrid: Universidad Rey Juan Carlos.

Qorchi, M. E., 2005. Las finanzas islámicas en expansión. *Finanzas & Desarrollo,* pp. 46-49.

Ruiz, P. C., 2009. Finanzas islámicas, el otro modo de hacer banca (I). *Estrategia Financiera,* Instrumentos Financieros(267), pp. 10-16.

Standard & Poor's, F., 2016. *Islamic Finance Outlook 2017 Edition,* s.l.: s.n.