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Concept of Islamic finance

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THE Quran and the Sunnah are the principal sources of Islamic law. Islamic finance signifies financial services, mechanisms, practices, transactions, and instruments that comply with provisions given in these fundamental Islamic texts. Thus, Islamic finance not only includes banking, but also capital formation, capital markets and all types of financial intermediation.

While some of these norms are shared by Islamic and western financial systems, certain norms are exclusive to Islam. In fact, some Islamic financial restrictions are severe enough to render certain western financial practices and transactions absolutely void. This assertion of religious law in commercial sphere reaffirms the claim that Islam is an all encompassing system, not just a set of prayers, acts of worship, and declarations regarding God's existence and omnipotence.

Coming back to the topic, derived from the Quran and the Sunnah, some of the main features of Islamic finance, in brief, are:
(1) Riba is prohibited in the strongest terms. Riba literally means "an excess", and most of the present-day Islamic scholars agree that it includes both usury and interest. The prohibition of riba is generally considered to be the most important of all Islamic financial principles.
(2) Gharar, which signifies ambiguity, uncertainty, or lack of specificity in the terms of a financial contract, is forbidden.
(3) As riba is prohibited, suppliers of capital become investors instead of creditors.
(4) Investment can only be made in permitted commodities and activities. For instance, one cannot deal in the import and export of alcohol. Similarly, it is not allowed to invest in a casino.
(5) Market prices must be determined by the forces of demand and supply. In other words, Islam envisages a free market.
(6) Information must be easily and equally accessible to all investors.

Based on the above-mentioned principles, there is a variety of Islamic financial instruments and transactions in vogue. Some of them are briefly explained below:
(1) Musharaka: It is a business structure in which the investor not only makes a financial contribution to the enterprise, but may also participate in managing the venture. Profits are shared between the parties according to a pre-determined ratio and losses are borne by them in proportion to their capital contributions. In terms of classification, this is an equity-based transaction.
(2) Mudaraba: In this arrangement, the investor provides the requisite financial resources, but does not participate in managing the enterprise. It is a form of partnership in which one party provides the funds while the other provides expertise and management. Profits are divided among the parties according to a mutually agreed ratio. Financial losses are borne by the investor alone. This is also an equity-based transaction.

(3) Murabaha: In this transaction, the finance provider, instead of advancing a loan to the party wishing to purchase goods or equipment, purchases those items and sells them to that party at cost plus a declared profit.
(4) Tawarruq: In it the finance provider buys an asset and immediately sells it to the client on a deferred payment basis. The client then sells the same to a third party for immediate delivery and payment. Consequently, the client receives a cash amount and has a deferred payment obligation for the marked-up price to the finance provider. The asset is typically a metal like copper or platinum.
(5) Ijarah: It is the leasing or hiring of a physical asset, and it is one of the fastest growing activities of Islamic financial institutions.
(6) Takaful: It is a form of insurance. It is an arrangement by a group of people to shield each other from loss or damage through the setting up of a defined pool of resources. Any member of the group who suffers such a loss is compensated in the form of monetary help from the common fund. In other words, it is a mutual self-help scheme between those who wish to support each other in difficult times.
(7) Sukuk: Also called “Islamic bond”, it signifies, speaking more accurately, an Islamic investment certificate. It is an asset-based investment as the investor owns an undivided interest in an underlying tangible asset that is proportionate to investment. The sukuk certificate is a proof of this ownership interest. The certificate holder is not only entitled to all the benefits that it entails including a share in the revenues generated by that asset, but is also entitled to share in the proceeds of the realization of the sukuk asset. Sukuk structures employ techniques that are well developed in conventional markets for structured finance, and have become a significant mechanism for raising finance in the international markets by institutions, corporations, and sovereign and state entities.

It must be mentioned that some of the prevalent transactions and instruments are not considered to be in conformity with Islamic law by all Muslim scholars. Those opposing these practices do so by pointing out the hidden or concealed elements of riba and gharar in them. For example, actual administrative fee is one thing and interest in the name of administrative fee is another. However, to most of the scholars, venture capital finance is closest to the actual Islamic finance. Thus, musharaka and mudaraba structures are favored by the majority.

In fact, every financial institution dealing in Islamic finance has a committee of Muslim scholars, called “shariah committee”, that determines whether a product or practice complies with Islamic law. As there is no set of binding uniform rules, shariah committees, at times, give conflicting rulings. There can also be a difference between two countries or regions. For instance, in Malaysia, Islamic financial restrictions are interpreted more liberally than in the Gulf.

Another shortcoming confronting Islamic finance is the shortage of qualified professionals. There are not many people who are equally skilled in conventional finance and Islamic law. A person well acquainted with conventional finance can easily understand any Islamic financial product; however, one cannot develop or market such a product without knowing the rules and logic unique to Islam.

To summarize, lack of uniformity in laws and procedures, and deficiency of skilled professionals are among the main hurdles faced by Islamic finance. However, the industry is growing – the Arab oil money being one of the main driving forces. This is evident not only from the number of banks and institutions established specifically for practicing shariah compliant finance, but also from the increasing number of western or conventional financial institutions engaging in Islamic finance operations.