

TOP TEN THINGS TO KNOW ABOUT ISLAMIC FINANCE

Authors:

Kin Sum KWAN

Partner for Skrine, Lex Mundi member firm for Malaysia

Ai Chin TAN

Assistant Legal Adviser for HSBC Amanah Malaysia Berhad

With the rapid growth and increasing popularity of Islamic finance as an alternative to conventional finance, here are top ten things to know about Islamic finance.

1. Philosophies of Islamic Finance

The rules underlying Islamic finance are derived from the religion of Islam. These rules govern the conduct of all financial transactions and economic activities under the Islamic financial system. The objectives and philosophies of Islamic finance are required to be consistent with the *Sharia* or Islamic law. *Sharia* is a collection of Islamic rules derived from the primary sources of the *Quran* and *Hadith* (which are Muslim texts) as well as the secondary sources of *Ijma* and *Qiyas*. *Quran*, according to Islamic tenets, is a divine revelation by *Allah* the Almighty to His Messenger, Prophet Muhammad, on Allah's directives relating to society and the proper conduct of society's members whilst *Hadith* is a set of publications on Prophet Muhammad's sayings, practice, sanctions and disapproval of things. *Ijma* is the unanimous consensus of qualified Muslim legal scholars in their interpretation and application of the teachings of the *Quran* and *Hadith* whereas *Qiyas* is the analogical deduction on some similar circumstances based on the provisions of the *Quran* and the *Hadith*. *Sharia* principles require financial transactions to be intertwined with genuine productive activities.

2. Core Prohibitions Affecting the Validity of Sharia Contracts

Islamic finance products are structured based on underlying *Sharia* principles. There are core prohibitions which must be strictly adhered to in *Sharia* contractual relationships to ensure the validity of *Sharia* contracts and the legitimacy of returns derived thereunder. *Riba* (interest), *gharar* (uncertainty) and *maisir* (gambling) are core prohibitions and its elements must not be present in *Sharia* contracts.

3. What is Riba, Gharar & Maisir?

Riba simply means a prohibited gain under *Sharia*. *Riba* would cover all gains from loans and debts, anything over and above the principal amounts. In the context of Islamic finance, *riba* can simply be construed as the prohibition of interest in the conventional sense, a concept prohibiting the making of money from money whether excessive or otherwise. The guiding principle of Islamic finance is the prohibition of interest based lending but capital providers and investors are not prevented from earning returns on their capital or investment appropriate to the duration of their commitment and exposure to risks. It is the exposure to risks over specific

time periods that justify the earning of returns which could be in the form of profits, rentals, fees or commission.

Gharar and *maisir* refer to uncertainty and gambling respectively. One of the underlying objectives of Islamic finance is to prevent dealings involving uncertainty, hazard, chance or uncontrollable risk leading to speculation. Consistent with this prohibition, Islamic banks are not to engage in speculative trade in shares, short-selling or trading in unidentified items. Derivatives of various kinds such as futures contracts, options, swaps and forward foreign exchange transactions where the rates are determined by interest differentials and fluctuation in currencies are similarly prohibited due to its speculative nature.

4. Key Islamic Contractual Principles for Products in Islamic Finance

Products offered in the Islamic financial system are commonly premised upon the following Islamic contractual principles:

Mudarabah: A partnership for participation in profit whereby capital is provided solely by one party whilst the labour (management of the venture) is provided by another party. Any profit arising from the venture would be shared between the two parties according to a pre-agreed ratio. All losses are borne by the capital provider whilst the worker receives no remuneration.

Musyarakah: Similar to *mudarabah*, this is a concept of joint venture except that all parties contribute towards the capital. Profits are shared on a pre-agreed ratio whilst losses are shared according to the proportion of capital contribution of each partner. The *Musyarakah* is akin to a partnership contract.

Murabahah: It refers to a sale of a commodity at a sale price that is fixed with specific reference to the cost of the commodity and a profit (mark-up) margin. The cost and profit margin must be expressly disclosed to the buyer.

Ijarah: It entails a leasing arrangement involving the transfer of the usufruct of a particular property to another person in exchange for rental payments from that person.

Istisna: It is an agreement where the purchaser requests the seller (either on its own or by procuring some third party to do so) to manufacture, assemble or construct a subject matter for a specified price and to be delivered at some future date agreed upon between the seller and the purchaser.

5. Unique Challenge to Islamic Finance 1: Human Resources

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

Product innovation can only progress in parallel with an increase in qualified *Sharia* scholars who have a good understanding of commercial issues and competent talents in other areas of Islamic finance such as Islamic product development specialists, Islamic banking legal practitioners and experts in risk evaluation specific to Islamic finance.

6. Unique Challenge to Islamic Finance 2: Product Innovation and Financial Engineering

In order to compete head-on with conventional finance, Islamic financial institutions need to grow in size and to broaden the suite of *Sharia* compliant products to match the type of products and instruments available under conventional finance. Islamic financial products must be on par with, if not better than, conventional finance in terms of diversity, cost effectiveness and ability to meet the risk and return requirements of customers whilst remaining *Sharia* compliant.

Islamic financial instruments are faced with pricing difficulties given that they cannot be associated with interest. There is a need to do away with the practice of benchmarking against inter-bank offered rates and come up with an Islamic indicator which is *Sharia* compliant for benchmarking of Islamic products.

On the positive side, the development of Islamic bonds or *sukuk* has given investors an alternative form of investment. *Sukuk* represents a trust certificate comparable to collective investment scheme that grants investors a share in the underlying asset along with the cash flow and risks that commensurate with such asset.

7. Unique Challenge to Islamic Finance 3: Sharia Incongruency

After the demise of the Prophet Muhammad, *Sharia* developed through the process of scholastic interpretations (*Ijtihad*) such as *Ijma* and *Qiyas* and other methodologies undertaken by Islamic scholars based on the *Quran* and *Sunnah*. This in turn led to the emergence of various schools of Islamic jurisprudence resulting in different interpretations of *Sharia* over time. There are four main schools or *mazhab*, namely *Hanafis*, *Shafi'is*, *Malikis* and *Hanbalis*.

The differences of interpretation of *Sharia* by the different schools have led to the subject of harmonization in *Sharia* interpretation. Differing or opposing *Sharia* interpretations can lead to legal uncertainties and affect investors' confidence. *Sharia* incongruency makes it difficult for financial intermediaries to structure cross-border transactions or develop new products with global appeal. There is therefore an urgent need for a common understanding and acceptance of applicable *Sharia* rules and standards to enable Islamic finance to become truly global in its reach.

8. Unique Challenge to Islamic Finance 4: Risks Unique to Islamic Finance

In Islamic financing, there is considerable financial risk through capital losses due to failed ventures and depreciating asset value during market turmoil. In times of economic crisis, investors in Islamic finance products are similarly vulnerable to volatile economic forces and are exposed to similar risks of illiquidity, credit crisis and overall economic risk.

Although Islamic finance prohibits *riba*, unfavourable fluctuations in commodity prices, currency and interest rates will concern many Islamic bankers as pricing for Islamic finance products are usually benchmarked against various inter-bank rates.

Offering non *Sharia* compliant products will affect the legitimacy of all returns derived thereunder from the Islamic perspective. It could cost the Islamic banks monetary and reputational loss in the event any of their products are found to be non-*Sharia* compliant.

9. Unique Challenge to Islamic Finance 5: Legislative and Regulatory Framework

The existing legislative and regulatory framework of many countries do not expressly cater for Islamic finance. As such, Islamic finance products must be developed with much caution,

delicately balancing legislative challenges and legal uncertainties. A great deal of innovation is required to counter legislative setbacks to Islamic products and security structuring.

There is also distinct disjunction between established conventional laws and *Sharia* rules which needs to be reconciled when structuring Islamic finance products. Further, the body of “Islamic finance specific” case law is relatively small.

The forum for effective alternative dispute resolution for Islamic finance is similarly lacking although the practices of arbitration (“*tahkim*”) and mediation (“*sulh*”) are recognized under *Sharia*.

10. Unique Challenge to Islamic Finance 6: Information Technology Constraints

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

The information in this Top Ten article should not be construed as legal advice or legal opinion on specific facts and should not be considered representative of the views of its authors, its sponsors, Skrine, HSBC Amanah Malaysia Berhad and/or the ACC. This Top Ten article is not intended as a definitive statement on the subject addressed. Rather, it is intended to serve as a tool providing practical information and references for the busy in-house practitioner and other readers.