



# Islamic Finance Enters the Mainstream

BY ROD MONGER, PH.D., CMA, CIPA, AND  
MUFEED RAWASHDEH, PH.D., CMA, CFM

**ALTHOUGH ISLAMIC FINANCE IS GAINING GROUND IN MANY COUNTRIES,  
IT FACES CHALLENGES SUCH AS MODIFICATIONS OF LAWS, REGULATIONS, AND  
DECISION-MAKING FRAMEWORKS.**

**R**ecent years have seen a marked growth in the Islamic financial services industry, which includes banks as well as insurance and investment firms that conduct business in accordance with Islamic religious laws. The International Monetary Fund (IMF) estimates that total Islamic assets are currently \$250 billion compounding at 15% annually. If this rate is sustained, that figure would catapult to \$500 billion within five years and \$1 trillion within 10.

More than 300 Islamic financial institutions now provide an alternative for an estimated 1.2 billion Muslims (20% of the world's population), mostly concentrated in the Middle East and Southeast Asia. Non-Muslims are also choosing Islamic finance as an option with some recent financial offerings experiencing 30% to 70% non-Muslim participation. Borrowers, especially foreign companies operating in Islamic countries, find that including Islamic sources of funds makes sense not only culturally, but also to diversify and deepen their access to capital.

Islamic finance is also gaining ground in Western

economies such as Great Britain, with its 2.5 million Muslims. Several banks in the country now offer Islamic services, and London, which has historic ties with the Middle East and other Muslim regions, has become a center for innovation for Islamic products and services. In the United States, Islamic finance has captured the interest of the Federal Reserve Board and the U.S. Treasury, which has appointed an in-house specialist to better understand international developments related to Islamic finance.

Three major factors are responsible for this trend. First, the resurgence of interest in Islamic business practices that had been suppressed under two centuries of Western colonization. Second, excess liquidity generated chiefly by oil and trade is stoking the coffers of Islamic financial institutions around the world. Third, the Islamic leadership, with a view to being a full partner in global finance, has focused on building an infrastructure to strengthen the Islamic financial industry.

With these developments, denizens of conventional finance have a heightened incentive to understand the nature of the Islamic financial services industry. The

following sections offer some insights into typical operations in Islamic banks, insurance companies, and investment firms and how the burgeoning infrastructure is laying the foundation for meaningful growth.

### MODERN ISLAMIC FINANCE

Islamic religious law provides detailed guidance for every facet of a Muslim's life—social, political, and economic. This includes the sanctioning of all commercial activity and, in the case of Islamic finance, approval of all products, services, and even specific transactions. This total integration of religion and commerce is unfamiliar to most non-Muslims who regard religion as a personal, rather than business, issue. In Islam, no such distinction exists.

Islamic law is richly detailed and difficult to distill into simple rules, but knowledge of two characteristics is helpful. First, Islamic law operates by exception: "All is acceptable in Islam, unless expressly forbidden." Second, the following five tenets help explain major differences:

1. *Interest is prohibited.* One cannot pay or receive interest.
2. *Islamic law matches risk and reward.* Because Islamic institutions eschew interest, banks share profits and losses with depositors and borrowers.
3. *Islamic law forbids making money from money.* There must be an intermediate transaction involving products or services that the financial institution at some point owned and possessed.
4. *Transactions may not involve uncertainty or speculation.* This would be *gharar*, which is a bargain with an unknown result. ("Do not buy fish in the sea.") These transactions are unacceptable because of the potential for future conflicts between contracting parties.
5. *Some practices are prohibited.* Islamic law forbids commerce related to alcohol and gambling, for example.

Despite these differences, Islamic financial institutions perform the same basic functions (albeit with minor variations) as their non-Islamic counterparts. Indeed, the most salient characteristic of modern Islamic finance, aside from its rapid growth, is how quickly it has developed competitive responses to the broad spectrum of conventional financial practices. With banks, for

example, products and services span the entire gamut from structured business financing to retail, home, and auto financing to debit and credit cards.

### ISLAMIC BANKING

Most Islamic funds come from two sources: *Qard hasan* and *mudaraba* contracts.

**Qard hasan** literally means "good loan." The *qard hasan* accounts, referred to as current accounts, pay no interest but typically offer checking and debit card privileges like conventional checking accounts.

**Mudaraba** refers to a trust-based partnership in which one party contributes capital and the other labor or expertise. At the beginning of the relationship, the contract determines the profit-sharing ratio. The typical form of *mudaraba* as a source of bank funds is the savings account. Unlike conventional interest-bearing counterparts, with *mudaraba*, savings account depositors provide capital while the bank acts as the funds manager. *Mudaraba* contracts can be either restricted or unrestricted. Unrestricted leaves the *mudarib*, the party responsible for providing labor and expertise, free to invest the funds at will. With restricted funds, the *mudarib* must invest only within a specified location or transaction type.

Common uses of funds in an Islamic bank include:

**Murabaha**—*Murabaha* is a form of financing (e.g., trade financing for inventory or equity financing for equipment) whereby the bank purchases the asset from the supplier, then sells it to the buyer at an agreed-upon price that includes a markup. The bank must own and possess the inventory at some point and pay for the purchase in full. The buyer gets immediate delivery but defers payment.

**Musharaka**—In this profit-sharing partnership (*musharaka* means "sharing"), both parties contribute capital and labor. For example, partners may use the *musharaka* for equipment leases. The partner or partners manage the *musharaka* operations, including purchasing equipment, arranging and amortizing leases, and collecting payments from customers. Partners share losses according to each party's equity participation and profits based on a pre-agreed-upon ratio.

**Bai al salam**—A sale contract for the future production

or delivery of commodities, the bai al salam defines goods and fixes the date of delivery. The buyer (i.e., the bank) must also make advance payment in full at the time the contract is struck. Commodities must be fungible, and the seller takes full responsibility for future delivery of the assets on an agreed-upon delivery date.

**Ijara**—The literal meaning of ijara is “to give something on rent.” Lessor and lessee mutually determine the consideration to be paid for using the asset, which is usually less than its useful life. Benefits and costs of each party should be stated clearly to avoid any ambiguity. At the end of the lease, the lessee may return the asset, renew the lease, or purchase the asset. The lessee, however, is not held accountable for losses beyond his or her control, and the lessor retains some responsibility for maintenance and repairs.

**Istisna**—Istisna is progressive financing for a contract between an employer and contractor to finance construction, assembly, or manufacture of an asset. The payment schedule in accordance with the work progress must be spelled out as well as the contractor’s duties and completion date.

**Mudaraba**—On the uses side, the bank may use mudaraba any number of ways; for example, to finance a new business enterprise where the involvement may be ongoing or limited.

## ISLAMIC INSURANCE

**Takaful**, which means “cooperative mutual insurance,” is a form of Islamic insurance where members are the insurers as well as the insured. As an industry, premiums totaled \$2 billion in 2005 and have been growing 20% annually in recent years. The emphasis on cooperative is important because, unlike conventional insurance that seeks to make a profit, Islamic insurance focuses on sharing risks.

Takaful has two primary types: family takaful for life, accident, health, and disability insurance, and general takaful for casualty lines, such as fire, auto, and personal accident, liability bonds, and workers’ compensation.

The Islamic insurance industry focuses on three operative models:

**Mudaraba**—Policy holders and the operator (the

insurance company) share both the rewards and risk based on a predetermined ratio. As with all mudaraba, one party provides the funds and the other the expertise.

**Al-wakala**—Policy holders share profits and risk, and the operator receives a fee for services to act as an agent (al-wakala means “agent”).

**Waqf**—Basically, waqf is a nonprofit model whereby policy holders donate to the charitable organization to assist those in need, the beneficiaries. The contract defines the amount to be received. After administrative fees are deducted, any surplus is distributed to the poor or reinvested.

Takaful is similar to conventional insurance in practice, but it does preclude interest-bearing investments like bonds. This proves to be a relatively minor stumbling block because funds can be productively invested in common stocks, real estate, investment trusts, mutual funds, and partnership investments.

Table 1 summarizes the different types of transactions for Islamic banks and insurance companies, their definitions or descriptions, claims on profits, and typical uses.

## INVESTMENT INNOVATIONS

The issue of whether Muslims can invest in stocks or mutual funds that hold those stocks introduces a number of complexities. Muslims must avoid companies that engage in forbidden activities, as already noted, and also companies that employ interest for borrowing or investing. If these conditions are met, ownership of equity shares is permissible.

The practical difficulty stems from the rarity of companies that meet these restrictions. One result is that the concept of equal share ownership has gained considerable popularity when applied to specific investments rather than to an entire entity. This has made investment sukuk a dynamic growth area within the evolving Islamic investment markets. Investment sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or in the ownership of the assets of particular projects or special investment activity.

Both corporations and governments issue investment sukuk. Sukuk financing is combined with other types of

**Table 1: Islamic Financing Transactions**

Transaction	Definition or Description	Claim on Profits	Typical Uses
<b>Mudaraba</b>	Mudaraba is partnership in profit whereby one party provides capital and the other party provides labor. (AAOIFI*, Sharia Standard 13)	Residual	Trade financing, equity financing, and insurance
<b>Musharaka</b>	Musharaka (contractual partnership) means an agreement between two or more parties to combine their assets, labor, or liabilities for the purpose of making profits. (AAOIFI, Sharia Standard 12).	Residual	Equipment leasing with partner
<b>Waqf</b>	Waqf is a charitable foundation or trust for the benefit of the poor.	Residual	Insurance
<b>Murabaha</b>	Murabaha is selling a commodity as per the purchasing price with a defined and agreed-upon profit markup, which may be a percentage of the selling price or a lump sum. This transaction may be concluded without a prior promise to buy, in which case it is called an ordinary murabaha, or with a promise to buy submitted by a person interested in acquiring the goods through the institution, in which case it is called a banking murabaha: i.e., murabaha to the purchase orderer. This transaction is one of the trust-based contracts that depends on transparency as to the actual purchasing price or cost price in addition to common expenses. (AAOIFI, Sharia Standard 8).	Fixed	Trade or equity financing
<b>Ijara</b>	In principle, an ijara contract is executed for an asset owned by the lessor. It is for a customer to request an institution to acquire the asset or to acquire the usufruct of an existing asset that the customer wants to take on lease. (AAOIFI, Sharia Standard 9)	Fixed	Lease term financing
<b>Istisna</b>	Istisna is a contract of sale of specified items to be manufactured or constructed, with an obligation on the part of the manufacturer or builder (contractor) to deliver them to the customer upon completion. (AAOIFI, Sharia Standard 11)	Residual	Long-term construction contracts
<b>Al-wakala</b>	Al-wakala is the contract of agency.	Fixed	Insurance
<b>Salam</b>	A contract of salam may be concluded using the word salam, or salaf, or sale, or any term that indicates sale of a prescribed commodity for deferred delivery in exchange for immediate payment of the price. (AAOIFI, Sharia Standard 10).	Fixed	Future sale of commodities

\*AAOIFI: Accounting and Auditing Organization of Islamic Financial Institutions

transactions already described. For example, sukuk can be used with murabaha and musharaka, the major difference being that the investment base is broadened and risk is diversified. Other investment sukuk include certificates for leased assets, usufructs, salam, istisna, mudaraba, and various agriculture-related transactions.

Prohibitions in Islamic law also rule out conventional derivatives that are linked to underlying elements, such as stocks, bonds, loans, currencies, commodities, and interest rates. Islamic financial institutions, however, have recently created Sharia-compliant ijara (lease) rental swaps, for example, whereby fixed rental pay-

ments can be exchanged for floating payments or vice versa. Instruments like these are relative newcomers, and innovation around derivatives and hedges are likely to see rapid development in Islamic finance over the next few years.

### **ISLAMIC GOVERNANCE**

The root of all Islamic law is the Qur'an, which Muslims consider to be the literal word of God or Allah, with the actions and pronouncements of the Prophet Mohammed as the next most authoritative source. Fiqhs (legal rulings) and fatwas (interpretations) clarify these seminal laws, a process from over the centuries that continues today. Together, these are referred to as Sharia. Islamic financial institutions rely on highly qualified Islamic jurists for fatwas to determine whether a product, service, or specific transaction is Sharia-compliant.

In practice, modern Islamic institutions have internal processes to deal with matters of Islamic law just as other institutions have departments for secular law. Internal specialists examine a proposed transaction and brainstorm its structure. In Islamic finance, if a transaction follows an accepted precedent or template, then internal reviews may suffice. If the product or service is new or will have high public visibility, as with retail offerings, the institution's Sharia board may need to provide an interpretation or fatwa. The board handles some issues by phone or e-mail, while others await the board's formal meeting.

Two important points should be kept in mind about Sharia boards. First, qualified jurists available to serve on boards are limited. Sharia boards typically have three to 15 members, and some jurists serve on the boards of as many as six or seven different institutions. As Sharia governance is concentrated in the hands of a few dozen leading jurists, one issue for the industry has been how to resolve this bottleneck, a necessary condition to achieve global economies of scale.

Second, Sharia is subject to interpretation. Consistency is high, although differences exist between jurists and Sharia boards. No court of final appeal exists, so multiple interpretations are possible.

One challenge for Islamic leadership has been how to address these issues. Efforts have been made to lever-

age the efforts of Islamic jurists and Sharia boards on which they serve by creating commonalities on selected issues. Perhaps the most notable initiative is the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI). This international consortium develops standards for accounting, auditing, governance, and ethics to ensure Sharia compliance. A 15-person part-time board issues standards and interpretations, and a separate 15-member Sharia Board oversees consistency with Islamic law.

The purpose of AAOIFI Standards is to achieve comparability and transparency through increased disclosure. AAOIFI Standards also create a platform of commonly accepted interpretations that individual institutions voluntarily use to leverage the efficiency of their compliance efforts. If the local institution's Sharia board accepts an AAOIFI Standard, then internal organizational efforts can be efficiently focused on exceptions and new products as well as services.

To date, the AAOIFI Standards Board has issued 25 accounting, five auditing, six governance, two ethics, and 30 Sharia Standards in addition to two conceptual frameworks on the objectives and concepts of Islamic financial accounting. Standards cover uniquely Islamic transactions as well as those familiar to both conventional and Islamic businesses: provisions and reserves, financial statement disclosures, foreign currency translation, and segment reporting. The AAOIFI also offers the Certified Islamic Professional Accountant (CIPA) certification, which is based on a four-part examination that includes Islamic financial systems; financial reporting for Islamic financial transactions; Sharia standards; and auditing, governance, and ethics. A second credential, the Certified Sharia Adviser and Auditor (CSAA), has recently been introduced.

### **REGULATION AND OVERSIGHT**

Another issue confronting the Islamic financial services industry is the need for a unified regulatory and supervisory structure. Because of the current level of regionalization, consensus about how regulation should be handled vis-à-vis conventional financial institutions is still forming. For example, some countries, such as Malaysia, favor separate regulatory structures for Islamic and conventional banks, while Arabian Gulf countries

tend toward single central bank control and regulatory structure for both.

To bridge independent efforts and interface efficiently with conventional finance, the Islamic Financial Services Board (IFSB) was created to set standards for the industry. Twenty-two agencies, including several national central banks, are members along with the International Monetary Fund and World Bank.

Initial IFSB standards have focused on risk management and capital adequacy. These early concerns are only expected given that Islamic banking lacks a developed interbank loan system that constrains liquidity. The result is that without ready access to funds to cover reserve requirements and without a single lender of last resort similar to the Federal Reserve Bank in the United States, Islamic banks tend to hold more reserves and short-term assets relative to conventional banks.

Other organizations, especially the Islamic Development Bank, are important players in the infrastructure, which continues to evolve. For example, Islamic organizations from four countries (Bahrain, Kuwait, Saudi Arabia, and the United Arab Emirates) recently created the Liquidity Management Centre to facilitate investment of surplus funds from Islamic institutions.

### **CHALLENGES AHEAD**

Limits remain on how Islamic banks can integrate into existing legal and regulatory frameworks. In many countries, conventional banking has evolved to be risk averse, accepting limited reward in the form of fixed interest payments with bounded risk. Indeed, debt is the major ingredient of leverage in conventional finance. Islamic finance's continued inroads into the mainstream will necessitate modification of laws, regulations, and decision-making frameworks.

Yet these issues are likely to be only minor distractions to further progress in Islamic finance rather than barriers. Even in the United States, where Islamic finance faces significant challenges from both state and federal regulation, progress is evident. For example, while the National Bank Act of 1864 contains prohibitions that effectively exclude some Islamic products, exceptions have been granted for certain ijara and murabaha transactions. And Islamic banks already have a track record in the U.S. home lending business: Three

have sold Sharia-compliant mortgages to Freddie Mac and one to Fannie Mae.

While predicting Islamic finance's future share of global markets and its penetration into non-Muslim economies is risky at best, further gains are assured. The incentive for the conventional financial community to understand and assimilate these developments is substantial. ■

*Rod Monger, Ph.D., CMA, CIPA, is an associate professor of accounting at Hong Kong University of Science and Technology. You can reach Rod at +(852) 2358 7583 or [acrod@ust.hk](mailto:acrod@ust.hk).*

*Mufeed Rawashdeh, Ph.D., CMA, CFM, is an associate professor of accounting at Dubai Aerospace University. You can reach Mufeed at +(971) 4 403 8741 or [mufeed.rawashdeh@dubaiaerospace.com](mailto:mufeed.rawashdeh@dubaiaerospace.com).*