

Islamic Financial Products

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Introduction

- Modern *birth* of Islamic financial institutions in early 1960's (Egypt).
- *High real* growth in 1970's and 1980's, in terms of number of institutions and assets under management.
- *Islamic finance* is part of the trend of proliferation of financial products, and prevailing segmentation of overall market for financial services.
- *Example:* modern growth of “ethical funds”, where certain types of investment are excluded, such as those in tobacco, armaments, and environment-damaging activities.
- At present over 200 institutions with \$300bn assets under management, compared with only \$50 million in late 1970's.
- Currently, Islamic financial institutions (IFI's) are operating in some 70 countries, many of which are nations with only a minority of Muslims in the population, e.g. UK, Luxembourg.
- IFI's have spread in Gulf, Middle-east, Asia, Europe, USA – practically wherever Muslims happen to be living in large numbers.
- Rate of growth of managed assets shows a minimum of **10%** p.a.
- Among major institutions in the gulf region:
 - a) **AL-Rajhi Banking and Investment** (set up '84)
 - b) **Kuwait Finance House** (set up '77)
 - c) **Dubai Islamic Bank** (set up '75)
 - d) **Islamic Development Bank** (set up '74 by Organisation of Islamic Countries).

- 1) Among major Western banks involved in Islamic finance:
 - 2) HSBC
 - 3) Lloyds TSB
 - 4) Royal Bank of Scotland
 - 5) Bank of Ireland.
 - 6) For the first time, the UK-based “Financial Services Authority” (FSA) granted a licence in 2004 to a new institution purporting to operate in accordance with *Sharia* (i.e. Islamic law). The new institution is called the “Islamic Bank of Britain” (IBB), which currently has branches in London, Birmingham, and Leicester. The IBB plans to have a total of 10 branches in the UK by end-2005.
 - 7) IBB provides saving and current accounts, as well as loans to its customers. The bank also started telephone and Internet banking.
 - 8) Many new courses (of various lengths) have sprung up at universities, colleges, and professional institutions.
 - 9) In addition to banks, many other Islamically- inspired financial entities have been set up. These have included insurance firms (*Takaful*), finance companies, investment funds, and trading firms purporting to function according to *Sharia*.

Aims & Nature

- Institutions attempting to *abide* by guidelines set in *Quran*. E.g. no dealing in fixed interest, gambling, alcohol, misrepresentation → impact on investment decisions and design of financial products.
- Avoidance of pre-set rate of interest is a cardinal feature, but not the only one.
- *Advisory board* (*Sharia* board) provides opinion on various aspects of operations, e.g. equity investments
- Western financial/investment firms *entered* fray. E.g. ANZ Investment Bank, HSBC Investment Bank, Deutsche Investment Bank, and others.

- One of the latest Western banks to cater for Muslims' requirements is Lloyds TSB (5th largest UK banking group), which launched in Feb 2005 its *Sharia*-compliant current account: no interest + no overdraft + debit card + no minimum balance + no fees.
- HSBC preceded Lloyds in offering a *Sharia*-compliant current account & mortgage facility.
- Variety of *financial products*, including individual portfolios, mutual funds, insurance services, mortgages, credit cards, personal loans. Each institution provides the products that it is competent to render, in terms of resources, size of market, customers' needs etc.

Main Features

- Several Muslim countries (Iran, Sudan, Malaysia, Saudi Arabia) have adopted banking on *Islamic* principles. This system can be summarised under the following headings:
 - a) Koran *forbids* charging of interest (*riba*) → money must be used productively. Financiers must not expect a guaranteed rate of return → Islam calls for participation & cooperative effort.
 - b) Return from lending/investing can be earned through *mark-up* pricing or profit/loss *sharing* in business ventures.
 - c) Customers may *share* in the profits (or losses) of financial institution, but do *not* exercise management control.
 - d) In *mortgage financing*, bank buys property and re-sells it at a *higher* price to customer → bank assumes some risk of volatile property prices, and client pays a monthly sum to bank. This is called *murabaha* (profit mark-up). Here, the customer will have, say, 20 years to repay the bank's advance. This is one possible scheme, as there are others. Bank and client may jointly purchase the property, and the client pays rent for the bank's share, while also paying gradually to buy the bank's portion of the equity.

- e) Another form of *murabaha* is in case of consumer durables (e.g. refrigerators, hi-fi, TV sets) → instalment plans often used → mark-up added to cost, and to cover other expenses.
- f) Banks/finance house can enter into certain permissible types of dealings with firms, including:
- 1) *Musharaka* (participation), i.e. two sides make a *joint* contribution to the capital of the company/project, and *share* in profits/losses on a *pro rata* basis.
 - 2) *Mudaraba* (speculation), where financing party provides *all* the capital, but gets only a pre-agreed *proportion* of profits → rest goes to firm/ entrepreneur.
 - 3) *ijara* (leasing), where bank purchases item (e.g. machinery or building) and other party *leases* it, paying a *user fee(rental)* → *ijara* frequently contains a provision for *eventual* ownership.
 - 4) *Murabaha*, where the financier acquires the goods/equipment/materials, and re-sells them with a mark-up to the other party, either at a lump-sum or gradually via instalments.

Sources

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