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Chapter 1

Start with 'Why'

Why Islamic Finance looks optically similar to Conventional Finance?

Mufti and the Church

It was a windy evening at Jamia Dar ul Uloom Karachi and I was waiting anxiously for my teacher Mufti Hassaan Kaleem who had just returned from his first ever visit to London, UK. Mufti Hassaan Kaleem is a student of Sheikh Taqi Usmani and Shariah Advisor of Dubai Islamic Bank. I asked him, one of the most frequently asked questions about Islamic Banking. *"Mufti Sahab, why is Islamic Banking optically similar to conventional banking?"* He smiled and said, *"Imran, I might not have been able to reply to your question appropriately if I had not visited London."* Then he narrated a story that changed my outlook towards Islamic Banking. He said that, during his stay in London he asked his host to take him to a masjid to offer prayer. While they were approaching to the place of worship, he realized that instead of going to a masjid, they were approaching a church. As they reached to the church's parking, Mufti sahib could not resist to ask his host that why is he taking him to a church to pray? The host requested him to wait till they got inside the church's main hall.

When they went inside the hall, Mufti Sahab was surprised to see that there were no benches, no cross, no pictures and no statues. Instead, there was a mimbar[2] where the imam was leading the prayer and behind him people were lined up on carpets offering salah with

[2]a pulpit in the mosque where the imam (prayer leader) stands to deliver sermons

jama'at[3]. So if a person looks from the outside, the building appears like a church while the reality is that it's a masjid where people are offering prayers as per the Islamic guidelines.

The host then told Mufti Hassan that since the population of Muslims in London has increased exponentially, there has been an increased need of mosques in different localities across London. However, as per the local building laws they cannot build a mosque at a place, which is not air-marked for a masjid by the concerned authorities. The scholars have given a fatwa to the Muslims of the UK that they can offer prayers as per Islamic guidelines within the church building after removing the statues, the pictures, the benches and the cross. Interestingly, the place where the bishop would stand in that church was right in the direction of the Ka'bah so they did not have to change the direction.

As church owners sell or lease their properties, the Muslims buy or lease these churches. Subsequently, while keeping the external outlook of the church intact they remove the cross, statues and pictures which are in contradiction to Islamic Shariah and replace them with mimbar and carpets to facilitate Muslims to offer prayers. Mufti Hassaan said, "This analogy explains the paradox of Islamic banking."

[3]gathering

The global financial laws and regulations are made keeping in view the conventional banking and financial system. Hence, Islamic banks from a layman's perspective optically look similar to conventional banks in terms of their outlook (just like the churches in London which have been converted into a mosque). However, when we look into the documentation processes, accounting treatments and Shariah compliance standards, we realize that Islamic Banking is very different from conventional banking from the inside- just like the masjid is different from the church.

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Start With Why

The million-dollar question is what does religion have to do with a worldly concept like business and finance? Moreover, more specifically, what has Islam got to do with finance? To know the answer, one must understand the philosophy of Islam as compared to other religions which are solely based on beliefs, called 'Aqa'id'and praying rituals, called 'ibadah'.However, the philosophical background of Islam is driven from the following declaration of Almighty Allah in Qur'an,:

الْيَوْمَ أَكْمَلْتُ لَكُمْ دِينَكُمْ وَأَتْمَمْتُ عَلَيْكُمْ نِعْمَتِي وَرَضِيتُ لَكُمُ الْإِسْلَامَ دِينًا

"Today, I have perfected your religion for you, and have completed My blessings upon you, and chosen Islam as Din (religion and a way of life) for you." (Al-Qur'an 5:3)

When the aforementioned verse was revealed, the Jewish community in the city of Medina mentioned to the companions of the Prophet Muhammad ﷺ that if this verse was revealed on the Jews they would have marked the day of its revelation and celebrated it. The Jews acknowledged that the verse indeed marks the completion of the religion of Islam and its selection as the only true religion to be followed till the Day of Resurrection.

Here it is important to understand that what is meant by the completion of the religion of Islam. Islam is composed of five segments, which go beyond the beliefs and praying rituals. In order to understand the essence of Islam, it is important to understand the following five components of Islam:

1. **Aqa'id:** The 'aqa'id' or belief system comprises of believing in the oneness of Allah, 'aqeeda-e-tawhid', and the finality of the Prophet Muhammad ﷺ, 'aqeeda-e-risalat'.
2. **Ibadah:** The 'ibadah' or religious obligations include Salah, fasting, paying zakat and performing hajj.
3. **Mu'ashrat:** Mu'ashrat refers to a person's public dealing in his or her social circle.
4. **Mu'amlaat:** Mu'amlaat refer to interpersonal dealing, particularly in the matters of business and finance.
5. **Akhlaqiyat:** 'Akhlaqiyat' refers to general mannerism and etiquettes while interacting with fellow members of the society.

Interestingly, out of the four volumes of hidayah, which are part of the Islamic Jurisprudence curriculum, only one book covers the topics of a'qaaid and ibadah and the remaining three books are related to Mu'ashrat, Mu'amlaat and Akhlaqiyat. This signifies that nearly three-fourth of the religion of Islam is focused on an individual's social interaction, in which the financial domain has been given importance.

If we look at the Qur'an, the number of prayers, the duration of fasts, the percentage of zakat, and the rituals of Hajj are not specified. These details are found in hadith narrations. However, financial matters, whether they are regarding laws of inheritance, the issuance of debt or the prohibition of interest, are mentioned explicitly in the Qur'an with detail.

Upright financial transactions whether they are regarding loan, participation in business, distribution of inheritance etc. are very important in the religion of Islam and the Muslims believe that they will be held accountable on the day of resurrection for such matters.
Ibn Mas'ud reported that the Prophet ﷺ said:

"The son of Adam will not pass away from Allah until he is asked about five things: how he lived his life, and how he utilized his youth, with what means did he earn his wealth, how he spent his wealth, and what did he do with his knowledge." - (Sunan al-Tirmidhī 2416)

Hence, the religion of Islam does not only talk about prayers, fasting and the pilgrimage but also about the mu'amlaat or financial dealings. In fact, the financial matters are given so much importance that they are part of the criteria of success on the day of judgment.

This is the reason why the companions of the Prophet ﷺ have noted and narrated hadith related to mu'amlaat. An entire branch of fiqh or Islamic jurisprudence called 'fiqh ul mu'aamlat' is based on this segment.

Anas ibn Malik reported that the Messenger of Allah, peace and blessings be upon him said:

"Seeking knowledge is an obligation upon every Muslim." (Sunan Ibn Mājah 224)

In light of this hadith, as you attempt to understand Islamic Finance and hence read this book, you are in the state of ibadah. May Allah

Subhana Wa Ta'la accept our efforts in writing and publishing this book and accept your efforts of spending time to obtain the knowledge of Islam.

Over the last two decades, Islamic finance has emerged as a shining star in the global financial market. Islamic finance further attracted special attention from the financial experts both in the industry and academia after 2007's Great Global Recession. Since the Islamic financial institutions did not experience the same level of financial crunch that their conventional counterparts went through, Islamic Finance became the center of focus of the global financial world. Exhibit 1 elaborates that after the 2007 financial crisis there has been an exponential increase in the interest of global academia in writing research papers in the field of Islamic finance.

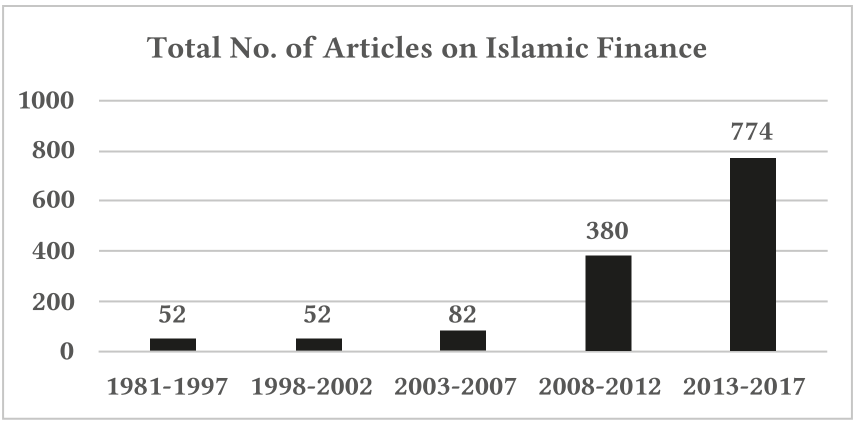


Exhibit 1

The Islamic Financial industry has witnessed consistent growth in the last decade despite the worldwide economic cycles. As per Thomson & Reuters' Islamic Finance Development Report[4] 2018, Islamic Financial industry grew to USD 2.4 Trillion with a CAGR of 6%.

[4]Islamic Finance Development Report 2018- Thomson Reuters

Besides its exponential growth, another reason for global attention towards Islamic Finance is its unique aspect of social, ethical and moral responsibility. Islamic financial institutions (IFIs) not only provide financial solutions to its customers but also aspire to contribute towards the overall social welfare of the society through the inherent nature of Islamic financial products.

Islamic Finance poses itself as an alternate to the conventional interest based financing model. Experts have argued that the concept of compounding interest has been a major contributor towards the unfair distribution of wealth. The former President Obasanjo of Nigeria is quoted to have said:

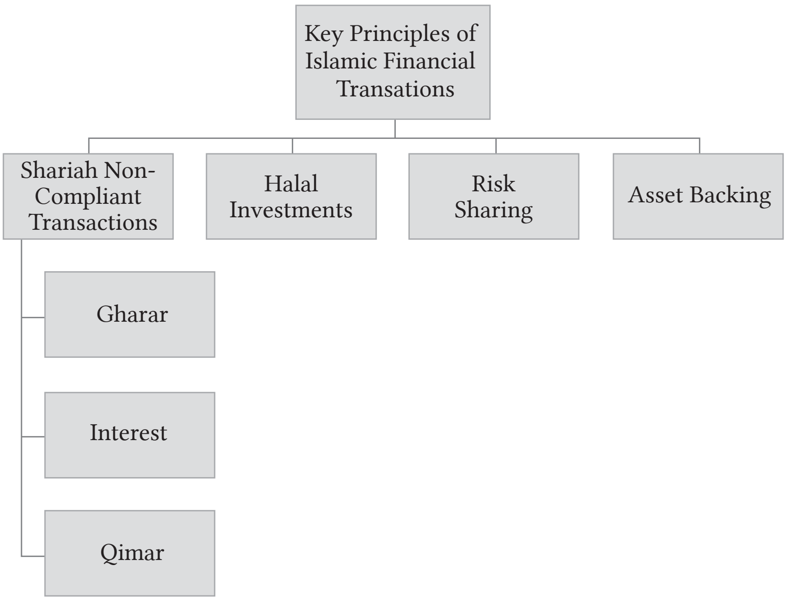
"All that we had borrowed up to 1985 or 1986 was about $5 billion and we have paid about $16 billion yet we are still being told that we owe about $28 billion. The $28 billion came about because of the injustice in the foreign creditors' interest rates. If you ask me what the worst thing in the world is, I would say it is compounded interest."

Obasanjo uttered these words in year 2000. This actually means that Nigeria was to pay a total of $44 billion over a loan of only $5 billion in about 15 years. A simple financial calculator exercise will help you determine the interest rate for this transaction:

Nigerian Debt ('000)	
Borrowed	$5,000,000
Owe	$44,000, 000
Years	15
Interest	15.60%

Guiding Principles of Islamic Finance

All Islamic Financial transactions are based on Shariah[5].A way of life prescribed by Allah (SWT) that encompasses all the aspects of human life. The term "Shariah compliant" signifies that the particular transaction is permissible under the Islamic law. All the Islamic Financial transactions have to be as per Shariah guidelines; hence, it is important to understand the term Shariah compliance.



Four Principles of Shariah Compliance

Shariah compliance is the main differentiating factor that distinguishes IFIs from their conventional counterparts. To ensure Shariah compliance, the following four principles need to be strictly followed in

[5]Islamic religious law that governs not only religious rituals but also aspects of day-to-day life in Islam

all financial transactions:

Interest Free: All Islamic Financial transactions have to be interest free. The concept of interest/riba will be discussed in detail in Chapter 4. The question arises, that how the Islamic banks generate their revenue. The answer is that they either charge a service fee or share a percentage of the profits with their customers/investors. These concepts will be discussed in detail in the book.

Halal Investments: As per the Shariah guidelines, all investments have to be made in halal avenues i.e. any investment in interest bearing financial products/ services and prohibited businesses such as alcohol, tobacco etc. are strictly not allowed. It is interesting to note that this practice is similar to the concept of Socially Responsible Investing (SRI). SRI, by definition are those investments that are done in ethical and socially responsible manner while ensuring that no harm is done with respect to the health and wealth of the customers in particular and the society in general.

Risk Sharing: The concept of risk sharing in Islamic Finance is based on the following Islamic Law of responsibility:

الغرم بالغنم

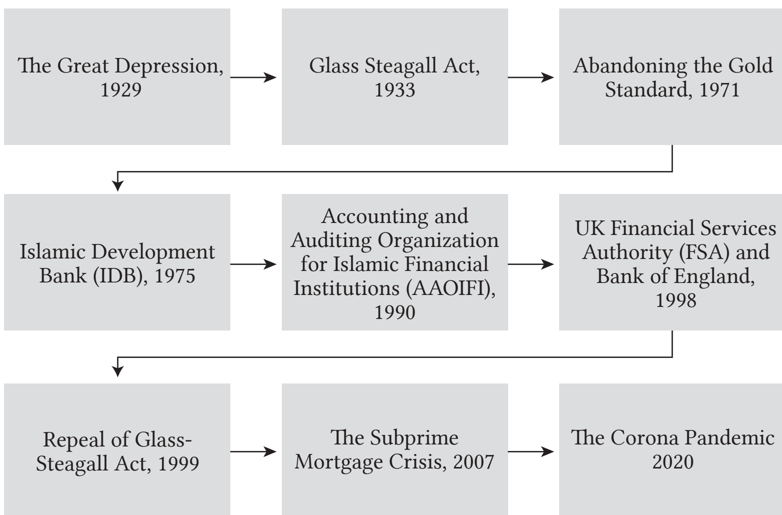
"Al ghurmu bil ghunmi"-Maxim 87, Majalla Al Ahkaam Al Adaliyaah

This law states that a person/institution cannot enjoy the benefit of anything unless they take its responsibility. In essence, it means that both the customer and the Financial Institution mutually agree to share the profit as well as the loss. This ensures overall transparency and responsibility in dealings among all partners, including the financial institution and the customers.

Asset Backing: Islamic Financial transactions have to be tied to assets either tangible or intangible. This ensures that the Islamic products and their valuations stay in line with the real economy, thereby curbing speculation and excessive credit expansion. Conventional financing, on the other hand, does not necessarily involve tangible/intangible assets to each of the transactions. This generates lots of speculation and uncertainty, besides allowing unjustifiable asset price inflation. The sub-prime mortgage crisis of 2007 is a case in point.

Conventional and Islamic Finance – Historical Background and the Post COVID World

There have been significant events, regulations and formation of governing bodies that have shaped up both of today's conventional and Islamic financial industries. Although it is not possible to account for all of such important events, we can get a basic understanding by learning a few major banking milestones from the past. Here is a brief overview:



The Great Depression, 1929: This was a period of worldwide economic downturn that began in 1929 and continued till the beginning of the Second World War. It resulted in slow economic output, extremely high unemployment and deflationary pressures across the world. In 1933, all US banks were closed and were permitted to reopen only after they would be declared solvent through government inspection.

Glass Steagall Act, 1933: This law separated the US banking industry into two divisions, namely commercial and investment banking. It was assumed that one of the major reasons of the Great Depression was that the commercial banks taking on too much risk with depositors' money.

Abandoning the Gold Standard, 1971: Under the previous gold standard, each country used to value its currency in terms of gold and took monetary actions to maintain the price. However, in 1971, the United States abandoned the standard and the US dollar replaced gold to become the international reserve currency.

Islamic Development Bank (IDB), 1975: IDB was established in 1975 in Saudi Arabia as an International Islamic Developmental Financial Institution. Its purpose was to promote foreign trade and economic co-operation among Muslim countries. Also in the same year, Dubai Islamic Bank was launched in UAE as the first Islamic Commercial bank.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), 1990: A non-profit organization AAOIFI was established in 1990 in Bahrain to prepare accounting, auditing and governance standards for Islamic Financial Institutions.

Now, AAOIFI has support from over 200 members from 45 different countries.

UK Financial Services Authority (FSA) and Bank of England, 1998: In 1998, the FSA showed its readiness to recognize Islamic Finance in United Kingdom (UK). In September 1995[6] , the Governor of the Bank of England recognized the growing importance of Islamic banking in the Muslim world and its emergence on the international stage as well as the need to put Islamic banking in the context of London's tradition of competitive innovation.

Repeal of Glass-Steagall Act, 1999: The US Congress repealed the Glass-Steagall Act by adopting the Gramm-Leach-Bliley Act. This removed restrictions between commercial and investment banking activities and allowed commercial banks to provide a broader range of services.

The Subprime Mortgage Crisis, 2007: Since the repeal of Glass-Steagall Act, the US banking industry was once again exposed to the moral hazards of the pre-Great Depression era. Subprime mortgage crisis severely affected the US and international banking industry. The crisis was triggered by a series of mortgage defaults and home foreclosures in the US. A number of mortgages issued beginning 2001 were made to subprime borrowers, who were not likely to repay the mortgage loans. As the borrowers started defaulting on their loans, major commercial as well as investment banks suffered a heavy decline in capital, leading to a recessionary environment in different parts of the world.

[6]Islamic Finance in the UK: Regulation and Challenges- Nov 2007

Corona Pandemic, 2020: The dawn of the year 2020 brought in a new challenge for our planet in the form of a pandemic called Covid-19 more commonly known as Coronavirus. What started as a health issue in the Chinese province of Wuhan in November 2019, the virus spread out across the globe and by March 2020, it resulted in the lockdown of virtually the whole planet. The severity of the crisis is reflected by the fact that on April 21, 2020 the U.S crude oil prices crashed to a level of negative 30 dollars per barrel[7] . The financial and banking industry will also affect from the corona pandemic. However, based on the experience of subprime mortgage crisis of 2007 the Islamic Financial Institutions will not be affected as much as their conventional counterparts. Reason being that Islamic banking transactions are asset backed and are not based on mere speculation and clean lending mechanism.

Conclusion

Today, in the post COVID world,we all are getting used to the new normal of social distancing and work from home. Both conventional and Islamic financial industries are clearly embracing themselves for a post COVID world. Islamic financial industry has made a promising start; it survived the big shock of sub-prime mortgage crisis, and is expected to pass through the COVID crisis of 2020 with the same resilience. If it continues to sustain its growth at the current pace, it will attract more attention from the global financial industry in the post pandemic world.

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