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Islamic Banking

An Introduction

By Shahzad Q. Qadri

A recent study by one of the nation's largest advertising firms shows that the American Muslim community has an estimated purchasing power of \$170 billion.

This community is now being noticed not only by companies, manufacturers, and advertisers of consumer goods but also by the financial industry. Banks, mortgage houses, and lenders alike are realizing the untapped potential of this market. As a result, the financial industry is racing to develop products and programs that are tailored to meet the needs of the American Muslim community.

This article introduces business lawyers to the basic concepts of Islamic banking, financing, and lending. Islamic banking is also often referred to as "*Shariah*-compliant" banking.

### **What is Islamic Banking?**

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of *Shariah*, known as *Fiqh al-Muamalat* (Islamic rules on transactions). There is a consensus among Muslim scholars that the Qur'an prohibits usury, the payment and/or collection of any type of interest (*riba*). In addition, Islamic law prohibits investing in businesses that are considered unlawful (*haraam*). These businesses may include, but are certainly not limited to businesses that sell alcohol or pork, or produce

gossip columns or pornography. In addition to the prohibition on *riba* and investing in *haraam* industries, the Qur'an clearly admonishes *gharar*, which can be interpreted to mean "contractual uncertainty and/or ambiguity," and *maisir*, which is gambling.

Due to these prohibitions, observant Muslims require specialized alternative arrangements from their banks. Many of the largest global financial companies, such as Deutsche Bank and JP Morgan Chase, have realized the untapped potential in this market and established successful and thriving subsidiaries that have strived to meet the requirements of Islamic banking. Other financial institutions are just realizing the potential of tapping into this relatively virgin market and are hurriedly developing products, programs, and subsidiaries to cater to the growing and affluent American Muslim market.

Unlike ordinary commercial banks whose operations are based on interest, Islamic banks operate an interest-free system and are guided by the common principle that depositors, instead of receiving a fixed return in the form of interest, share the risk of investment and take part of the resulting profits or bear part of the losses.

The basic principles of Islamic banking are the sharing of profit and loss and the prohibition of *riba* (interest). Among the common Islamic concepts used in Islamic banking are profit sharing (*Mudharabah*), safekeeping (*Wadiyah*), joint venture (*Musharakah*), cost plus (*Murabahah*), and leasing (*Ijarah*). Each concept is explained below.

### ***Mudharabah***

*Mudharabah* is a contractual agreement between a financial institution or a capital investor and an entrepreneur. This can be viewed as "venture capital" funding. Essentially, it is a contract that provides for profit sharing between the money source and the entrepreneur. In such contracts, the entrepreneur can mobilize the funds of the former for its business activities. While the financing entity provides the funding for the business venture, the entrepreneur provides expertise, labor, and management. Profits made are shared between the bank and the entrepreneur according to a predetermined ratio. In the event of a loss, the bank loses the capital, while the entrepreneur loses his provision of labor. It is this financial risk, according to the *Shariah*, that justifies the bank's claim to part of the profit. The profit sharing continues until the loan is repaid. Such participatory arrangements between capital and labor reflect the Islamic view that the borrower must not bear all the risk/cost of a failure, resulting in a balanced distribution of income and not allowing a lender to monopolize the economy. In essence, this scheme reflects the Islamic view of balance between the parties: the borrower must not bear all the risk/cost of a failure, and the lender must not receive all the profits.

### ***Wadiyah***

In this arrangement, the depositor and the bank enter into an agreement where the bank essentially acts as the keeper and trustee of the funds deposited. However, while serving as a trustee, the bank is entitled to utilize the funds on deposit for its business endeavors. The bank guarantees a refund of the entire deposit or whatever balance remains upon demand by the depositor. At its discretion, the bank may periodically reward the depositor with *hibah* (a gift) in appreciation for allowing it to use the depositor's funds. The *hibah* in most instances is a cash payment equivalent to an interest payment. However, it is not considered *riba* as there is no guarantee of such payments, nor is the amount generally fixed. The amount, frequency, and duration of the *hibah* is entirely at the bank's discretion.

### ***Musharakah***

*Musharakah* is what we commonly refer to as "joint ventures." In these transactions, two or more persons/entities combine their capital or labor together to share the profits, enjoying similar rights and liabilities. This method of financing is often used in investment projects, letters of credit, and the purchase of real estate or property. While the investment by each partner may be unequal, each partner retains an equal right to management and participation in the business.

In essence, every partner is an agent for the other, as all the partners benefit from the *Musharakah* business. When a contract of *Musharakah* is made, the condition of agency is automatically presumed to exist in the contract. While every partner enjoys equal rights in all respects, any condition regarding participation in the administration of the *Musharakah* or variation in the share of profit on this ground is valid. While every partner has a right to participate actively in the affairs of *Musharakah* should they desire, they can choose to relinquish and waive that right without any repercussions. For example, where a bank enters into a fast food venture with an individual, it will most likely waive any and all rights as to the day-to-day management of the enterprise.

The bases for entitlement to the profits of a *Musharakah* are capital, active participation in the *Musharakah* business, and responsibility. Profits are to be distributed among the business partners on the basis of the proportions settled by them in advance. The share of every party in the profits must be determined as a proportion or percentage. No fixed amount can be settled for any party. However, Muslim scholars have unanimously agreed that in this method of financing, losses shall be allocated to each partner in proportion to the capital invested.

### ***Murabahah***

This concept refers to the sale of goods at a set price, which includes a profit margin agreed

to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a motor vehicle), with a fixed rate of interest equal to the profit margin. The bank is not compensated for the time value of money outside of the contracted profit margin. This concept is widely utilized in Islamic mortgage transactions. In such transactions, instead of loaning the buyer money to purchase the property, the bank might buy the property itself from the seller, and then re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in installments. However, the fact that it is profit cannot be made explicit and, therefore, there are no additional penalties for late payment. In order to protect itself against default, the bank requires strict collateral. However, the goods or land is registered in the name of the buyer from the start of the transaction, and accordingly, the buyer is in fact able to benefit and receive tax credits.

### ***Ijarah***

The concept of *Ijarah* simply refers to the idea of leasing, renting, or wages. However, under the purview of Islamic finance, *Ijarah* means to sell a benefit or a use for a fixed price or wage. Under this concept, the bank makes available to the customer the use of assets/equipment such as a plant, office automation, or motor vehicle for a fixed period and price. The benefits derived and the reasons behind this form of financing are very similar to those that drive major American corporations to lease rather than purchase equipment, tools, offices, and automobiles.

However, Islamic banks provide a variation to the leasing model utilized by American corporations. This method of financing is known as *Ijarah-Wal-Iqtina*. This is a contract under which a bank provides equipment, a building, or other assets to the client under an agreed rental, together with a unilateral undertaking by the bank or the client where at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rental and purchase price are fixed in such a manner that the bank gets back its principal sum along with profit over the period of lease.

While these are some of the crucial methods of Islamic financing, these by no means are exhaustive. This simply is a sampling of the schemes available to any financial institution wishing to venture into Islamic banking.

### **Establishing an Islamic Bank**

Contrary to the perception at large, a financial institution does not have to be an Islamic entity, nor does it have to be owned by Muslims, to sell and/or carry *Shariah*-compliant

products. Most conventional financial institutions and banks have offered and are successfully offering *Shariah*-compliant products alongside traditional Western-style products. All that is needed is a board of religious scholars that can approve the products and operations. As such, it has become a common practice for Islamic and non-Islamic banks to appoint their own boards of *Shariah* scholars. However, due to the scarcity of the availability of such experts, many banks have had to turn to the same group of scholars and experts. This has resulted in a unique phenomenon that has promoted a level consistency and uniformity across the board as to the services and products being offered by the financial institutions.

Any financial institution wishing to enter the market of Islamic finance should, as a preliminary matter, appoint a *Shariah* board, or, at the very minimum, a *Shariah* counselor who is well versed in Islamic law and Islamic economics. This preliminary step will help minimize any risks for the institution against claims that the Islamic financial products being offered by the institution fail to comply with the principles of Islamic law and economics.

Additionally, any financial institution choosing to broaden its offerings by choosing to integrate *Shariah*-compliant products should ensure that the rulings and decisions of its internal board are consistent and on par with those of the *Shariah* boards of foreign supervisory agencies, specifically: (1) the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and (2) the Islamic Financial Services Board (IFSB). These two agencies were created in an effort to achieve a level of consistency and uniformity internationally as it relates to Islamic finance and products. The AAOIFI has undertaken the responsibility of issuing internationally recognized and accepted *Shariah* standards on accounting, auditing, and governance matters, while the IFSB is responsible for the development and issuance of standards for the effective supervision and regulation of Islamic financial institutions.

Another entity that cannot be underestimated is the Islamic Fiqh Academy, which was established in 1988 in Jeddah, Saudi Arabia, under the auspices of the Organization of the Islamic Conference (OIC). Although the rulings and opinions pertaining to economic and financial matters issued by the Academy are not officially binding, they are highly respected and certainly considered by Muslim scholars, Islamic finance practitioners, and policymakers alike.

## **Segregation of Funds**

A crucial principle in Islamic finance is the requirement to maintain the moral purity of all transactions. It is vital for any bank or financial institution intending to offer *Shariah*-complaint products not to commingle funds intended for Islamic investments with those of

non-Islamic investments. This requirement is not based on the assumption that the activities of non-Muslims are intrinsically impure, but rather the rationale underlying this principle is one of prudence, taking all necessary precautions to ensure that Islamic funds do not become mixed with other funds that may be involved with *riba*, *gharar*, or *haram* activities.

## **The Future of Islamic Banking**

Islamic banking is here to stay. Unlike products with short shelf lives, bankers at some of the most respected financial institutions predict that Islamic finance will be the world's fastest-growing banking sector for years, with a predicted modest estimate of 20 percent annual increase in deposits. Despite this rapid growth, Islamic banking and finance is still uncharted territory for most practitioners in conventional banking.

However, bankers, practitioners, and policymakers are realizing that Islamic banking is big business that is only getting bigger. Financial institutions that are reluctant or hesitant to enter the market now risk suffering an expertise deficit later, as the number of professionals trained to develop and structure *Shariah*-compliant products is relatively small. The number of religious scholars qualified to certify these products is even smaller.

Nevertheless, this has not deterred financial institutions nor non-Muslim governments from entering the Islamic banking market. Japan is planning to become the first non-Muslim country to issue *Shariah*-compliant bonds. In the summer of 2006, the United Kingdom's prime minister, Gordon Brown, announced that his government was revising its laws to make London the "gateway" for Islamic finance in Europe. Other nations, such as Malaysia, have proposed substantial tax incentives for the Islamic financial sector.

In fact, there are currently more than 300 Islamic financial institutions spread over 51 countries. Additionally, there are well over 250 mutual funds that are considered to be *Shariah*-compliant.

While Islamic banking is somewhat of an anomaly, with the increasing purchasing power of the Muslim American community and the Muslim world at large, financial institutions can no longer afford to ignore this niche market. In order to remain competitive, banks and financial institutions alike will have to sooner or later consider offering *Shariah*-compliant products.

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