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A Primer on Islamic Finance: Definitions, Sources, Principles and Methods

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Islamic finance is one of the most rapidly growing segments of the global financial system. However, despite the increasing importance of Islamic finance, particularly in developing economies in the Middle East and South-East Asia, religious and social complexity has acted against a fuller understanding by regulators, policymakers, researchers and practitioners. This paper provides a succinct and accessible analysis of the definition, sources, principles and methods of Islamic finance. This serves as a suitable starting point for further work into Islamic finance and many of the pressing regulatory, supervisory and competitive issues that remain as yet unaddressed.

JEL classification: G20; N25; P40; Z12

Keywords: Islamic finance, Islamic banking; cultural finance

1. Introduction

Islamic finance – financial institutions and products designed to comply with the central tenets of *Sharia* (or Islamic law) – is one of the most rapidly growing segments of the global finance industry. Starting with the Dubai Islamic Bank in 1975 (and operations in the United Arab Emirates, Egypt, the Cayman Islands, Sudan, Lebanon, the Bahamas, Bosnia, Bahrain and Pakistan), the number of Islamic financial institutions worldwide now exceeds over three hundred, with operations in seventy-five countries and assets in excess of US\$400 billion (El-Qorchi 2005).

Though initially concentrated in the Middle East (especially Bahrain) and South-East Asia (particularly Malaysia), Islamic finance principles are now increasingly found elsewhere. This includes developing economies where the financial sector is almost entirely Islamic (such as Iran and Sudan) or where Islamic and ‘conventional’ financial systems coexist (including Indonesia, Malaysia, Pakistan and the United Arab Emirates) (El-Qorchi 2005). It also includes developed economies where a small number of Islamic financial institutions have

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been established and where large conventional banks have opened Islamic financing windows (such as in Europe and the United States) (Archer and Rifaat 2002).

The global proliferation of Islamic financial institutions has been accompanied by parallel developments in Islamic financial products. Starting with simple prohibitions on usury, investment in tobacco, alcohol, gambling and armaments and a requirement that all financial transactions be based on real economic activity, Islamic financial products now cover a broad range of financial services, including funds management, asset allocation, payment and exchange settlement services, insurance and reinsurance, and risk management. For almost all conventional financial products there is nearly always an analogous Islamic finance product. For example, Islamic securities now account for 42 percent of outstanding private debt securities and 25 percent of outstanding bonds in Malaysia; the sovereign (and quasi-sovereign) and corporate *Sukuk* (Islamic medium-term note) market has been tapped by the German State of Saxony-Anhalt in a €100 million issue in 2004; and the Dow-Jones Islamic Market Index and the Financial Times Stock Exchange Global Islamic Index provide benchmarks for the more than 130 Islamic equity mutual funds worldwide (El-Qorchi 2005).

Unfortunately, this rapid development and the substantial cultural and language barriers that exist have acted against a fuller and more widely held understanding of Islamic finance. This is problematic in a number of respects. To start with, regulators worldwide are now faced with the need to standardize and harmonize regulation and supervision in systems that may include Islamic institutions and products (Choudhry and Mirakor 1997; Kahf 1997; El-Hawary et al. 2004). While a number of specialised Islamic organisations assist in this process – the Accounting and Auditing Organization for Islamic Financial Institutions (2007), the Islamic Finance Services Board (2007), the International Islamic Financial Market (2007), the Islamic Development Bank (2007) and the International Islamic Rating Agency (2007), amongst others – yet other national and international regulators also need to be involved when considering the differences in behavioural assumptions between Islamic and conventional financial institutions, firms and products. As examples of this wider interest in Islamic finance, the International Organisation of Securities Commissions (2004) commissioned a recent taskforce on Islamic capital markets; the World Bank (2007) “...recognizes the wishes of its member countries to develop their financial system according to their cultural and ethical principles...To enhance its expertise on Islamic financial services, the Bank is engaged in the analysis of their corporate governance, transparency, market

discipline and risk management features”; and the International Monetary Fund’s (2007) *Finance and Development* series frequently deals with topics of interest in Islamic banking [see also Errico and Mitra (1998)].

Concomitantly, there is ongoing debate over the fact that Islamic banks do not separate fund management and investment activities from commercial banking. This may cause technical difficulties for supervisors and regulators (Sundararajan and Errico 1997). Likewise, the risk-sharing nature of liability contracts has raised concerns on the definition of capital and capital adequacy ratios: some have argued that the appropriate regulatory framework for Islamic banking must place a greater emphasis on operational risk management and information disclosure than is normally the case with conventional banks (El-Qorchi 2005). Moreover, many developing economies are grappling with the design of optimal supervisory and regulatory regimes for systems including Islamic institutions and products, and whether these should treat Islamic finance identically, uniquely or with slight modification to conventional institutions and products (Wilson 2002). A better understanding of Islamic finance is called for in all respects.

At the same time, researchers in conventional finance have been restricted in their efforts to investigate these and other important issues by the strong interface between religion and finance and the social and cultural barriers that act against the acquisition of this knowledge. This necessarily impairs research into Islamic finance, its role and potential impacts. In a similar manner, practitioners in conventional finance firms may find it difficult to gain an understanding of Islamic finance necessary for the design of compliant products and an awareness of the competitive position of Islamic finance firms and products.

Accordingly, the purpose of this article is to provide a fundamental introduction to the definition, sources, principles and methods of Islamic finance. While several publications are already available concerning Islamic finance concepts [see, for example, Anwar (1995), Haron (1995), El-Gamal (2000), Warde (2000), Lewis and Algaoud (2001), Iqbal and Llewellyn (2002), Abdul-Gafoor (2003), Obaidullah (2005)] in nearly all cases these deal with specific aspects and/or abstract from the basic principles necessary for the first-time reader. This article starts with the religious and social underpinnings of Islamic finance and links this with the principles and methods of contemporary Islamic products. It therefore provides guidance to those conducting empirical research in Islamic finance as well as an aid

for policymakers, managers, and practitioners interpreting the outcomes of Islamic finance studies.

The paper is divided into six main sections. Section 2 offers some definitions of Islamic finance. Section 3 highlights the historical background and religious context of Islamic finance. Section 4 outlines the main principles of Islamic finance. The main methods of Islamic finance are presented in Section 5, and Section 6 briefly focus on Islamic banking. The final section concludes.

2. Definition of Islamic finance

Islamic finance is defined as a financial service principally implemented to comply with the main tenets of *Sharia* (or Islamic law). In turn, the main sources of *Sharia* are the *Holy Quran*, *Hadith*, *Sunna*, *Ijma*, *Qiyas* and *Ijtihad*. The *Holy Quran* is the book of revelation given to the Prophet Muhammad; *Hadith* is the narrative relating the deeds and utterances of Muhammad; *Sunna* refers to the habitual practice and behaviour of Muhammad during his lifetime; *Ijma* is the consensus among religion scholars about specific issues not envisaged in either the *Holy Quran* or the *Sunna*; *Qiyas* is the use of deduction by analogy to provide an opinion on a case not referred to in the *Quran* or the *Sunna* in comparison with another case referred to in the *Quran* and the *Sunna*; and *Ijtihad* represents a jurists' independent reasoning relating to the applicability of certain *Sharia* rules on cases not mentioned in either the *Quran* or the *Sunna*.

A large number of Islamic finance definitions are found in the literature, ranging from the relatively simple definitions for specific aspects (say, Islamic banking) to more complex definitions covering all financial operations. Warde (2000, p. 5), for example, defines Islamic finance as follows: "Islamic financial institutions are those that are based, in their objectives and operations, on Quran's principles (principles of the Muslims' holy book)". This particular definition suggests that Islamic financial firms are not just banks, but also other types of financial intermediaries that employ *Sharia* principles. The other point of departure is that the *Sharia* ostensibly requires the adjustment of all aspects of Muslims' lives and the formation of a complete moral system. According to Iqbal (1997), while the prevailing Western financial system focuses on the capitalistic features of economic and financial processes, Islamic

finance aims to make an actual moral and equitable distribution in resources and social fairness in all (Muslim) societies.

3. Historical and religious context

The development process of Islamic finance commenced at the beginning of the 7th Century when Muhammad is professed to have received revelations directly from *Allah* (the God of Islam). Moore (1997 p.3) regards the actual date as 613AD when Muhammad was about forty years old. At the time, the doctrine of financial operations during Muhammad's era was derived directly from the *Holy Quran* and the *Sunna* (traditions) of Muhammad. Since then, while Islamic *Sharia* (*Quran and Sunna*) has ostensibly coordinated all financial transactions between Islamic persons, there has been a continuing process of mutual adjustment between *Sharia* and the actual financial practices of Muslim societies.

In Muhammad's lifetime, Islamic methods of finance often drew upon examples from the Prophet's experiences. Kahf and Khan (1993), for example, have pointed out that Muhammad was the first to use the *Mudarabah* (silent partnership) in trade with a rich woman named Khadijah (who later became his wife). At the time, Muslims used to practice *Musharakah* (full partnership) when operating large commercial enterprises under a profit/loss sharing principle. In addition, Muhammad made it permissible for people to use sale on credit (*bai salam*) which was to finance consumption or production without usury and he encouraged Muslims to provide benevolent loans (*Quard Hassan*) (Kahf and Khan 1993). The ongoing Islamisation of Arabic countries meant that *Sharia* rapidly spread to both Muslims and non-Muslims at this time.

After the death of Muhammad in 632AD, a great expansion of Islam occurred throughout the Arabic states and in large parts of the non-Arab world. The Islamic state in this 'golden age' was dominant in three continents, Asia, Africa and Europe. According to Moore (1997) the Islamisation of economic systems during the four centuries following Muhammad's death reached Morocco and Spain to the west, India and China to the east, central Asia to the north and Africa to the south. The extension of Islamic tools of finance is also indicated by historical records of contracts registered between businessmen at the time, including *Mudarabah* and *Musharakah*. Islamic finance practices continued largely unchanged until the beginning of the 19th Century (Warde 2000).

From the nineteenth century, nearly all Muslim countries fell under the control of the Western colonial powers (France in North Africa, Britain and France in the Middle East, Britain in the Indian sub-continent and Britain and The Netherlands in South-East Asia), effectively dividing the Islamic world into many small states. Anwar (1995) argues that by the mid-nineteenth century almost all Muslim-controlled areas fell to the Western colonial powers and thus the existing financial scheme which complied with *Sharia* was effectively replaced by the capitalist system. From then until the second half of the twentieth century, most Muslim economies were dominated by the economic traditions and systems of Western Europe (Moore 1997). However, while commercial banks, insurance companies and other types of intermediary firms employed conventional methods of finance (mostly as branches or agents of institutions in the colonising country), Islamic methods of finance were still often practised between individual Muslims.

With the independence of the Arabic countries from the colonial powers by the second half of the twentieth century, many Islamic economies also became more independent. As a result, Muslim economists started reconsidering the application of Islamic finance into a formal banking industry. Iqbal and Molyneux (2005) suggest the first attempt to establish an Islamic bank was in 1971 when the Egyptian government established the Nasser Social Bank. This bank provided a number of Islamic financial products, including interest-free loans to the poor, student scholarships and small business credit on a profit/loss sharing basis. This was followed by the Dubai Islamic Bank in 1975 and subsequent rapid expansion. El-Qorchi (2005) attributes the rapid growth in the last thirty years to several key developments. First, the strong demand from immigrant and non-immigrant Muslims for *Sharia*-compliant financial services and transactions; second, the growing oil wealth found in the Middle East; and third, the increasing competitiveness of Islamic finance products vis-à-vis their conventional counterparts. Other factors likely include the rise of fundamentalism and resurgence of strident Muslim practice in many communities and the incentives offered by governments in some Muslim countries to encourage the establishment of Islamic banks.

4. Principles of Islamic finance

Islamic finance is controlled by *Sharia*, the legal framework of Islam and its Quranic interpretation, along with the teachings of *Sunna*. This framework provides guidelines for people to follow the principles of the *Holy Quran* and the *Sunna* in their decision-making in

all aspects of life. Financial transactions are one of the more important dealings controlled by *Sharia*, ostensibly to ensure the more equitable distribution of income and wealth among Muslims in Islamic economies.

The principles of Islamic finance have been extensively studied by Muslim and non-Muslim scholars alike (Wilson 2006; Metwally 2006; Iqbal and Molyneux 2005; Siddiqi 2004; Akacem and Gilliam 2002; Zaher and Hassan 2001; Lewis and Algaoud 2001; Al-Jarhi and Iqbal 2001; Warde 2000; El-Gamal 2000; Dar and Presley 1999; Dumale and Sapcanin 1999; Abdul-Gafoor 1999; Moore 1997; Iqbal 1997; Haron 1995; Kahf and Khan 1993; Metwally 1993). The general principles are as follows: (i) the prohibition of *Riba* (usury or excessive interest) and the removal of debt-based financing from the economy; (ii) the prohibition of *Gharar*, encompassing the full disclosure of information and removal of any asymmetrical information in a contract; (iii) the exclusion of financing and dealing in sinful and socially irresponsible activities and commodities such as gambling and the production of alcohol; (iv) risk-sharing, the provider of financial funds and the entrepreneur share business risk in return for shares of profits and losses; (v) materiality, a financial transaction needs to have a ‘material finality’, that is a direct or indirect link to a real economic transaction; and (vi) justice, a financial transaction should not lead to the exploitation of any party to the transaction.

4.1 Prohibition of *Riba* (usury or interest)

Al-Jarhi and Iqbal (2001) and Siddiqi (2004) argue that *Riba* is an Arabic word which means any increase or growth in a loan that must be paid by the debtor to the lender, regardless of whether the increase is large or small. Metwally (2006, p. 17) links the concept more closely to usury: “Usury is translated to mean *Riba* which literally means an excess or addition above the principle lent. Since interest, however small, is an excess over the capital lent”. Of course, *Riba* (usury or interest), while historically practiced by many Near East populations such as the Mesopotamians, Hittites, Phoenicians and Egyptians, had also been condemned by other religions before the establishment of Islam. For example, the Jewish Torah and later sections of the Hebrew Bible criticize interest-taking, but interpretations of the Biblical prohibition vary. One common understanding is that Jews are forbidden to charge interest upon loans made to other Jews, but are allowed to charge interest on transactions with Gentiles.

Similarly, the prohibitions against usury in Christian theology have ranged between straight prohibitions on interest to papal edicts against excessive interest.

It is generally argued that the prohibition of *Riba* (usury or interest, whether small or large) is the most important principle of Islamic finance. Any interest or predetermined payment over and above the actual amount of principle is strongly prohibited by the *Holy Quran* and the *Sunna*. Metwally (2006, p.16-17) translates the evidence from the *Holy Quran* and the *Sunna* as follows:

Those who devour usury will not stand except as stands one whom The Evil One by his touch hath driven to madness. That is because they say: Trade is like usury. But Allah hath permitted trade and forbidden usury (2:275).

O Ye who believe! Fear Allah and give up what remains of your demand for usury, if Ye are indeed believers. If Ye do it not, take notice of war from Allah and His Apostle. But if Ye turn back, Ye shall have your capital sums: Deal not unjustly and Ye shall not be dealt with unjustly (2:278-279).

The Prophet has condemned both the receiver and the giver of usury. It is claimed that the prophet said: Sell not gold for gold except in equal quantity, nor sell silver for silver except in equal quantity, nor sell anything present, for that which is absent.

In this tradition, gold and silver were used as money in Muhammad's era when usury on these materials was forbidden. In addition, El-Gamal (2000, p.3) translates another *Hadith* (or message) from the *Sunna* that:

Muslim narrated on the authority of Abou Said Al-Khudriy: Bilal visited the Messenger of Allah with some high quality dates, and the prophet inquired about their source. Bilal explained that he traded two volumes of lower quality dates for one volume of higher quality. The Messenger of Allah said: "this is precisely *Riba!* Do not do this. Instead, sell the first type of dates, and use the proceeds to buy the other.

It is very clear from the above that *Riba* (usury or interest) is strictly forbidden.

Even though there are no specific verses in the *Quran* or messages from the *Sunna* providing reasons for the forbidding of *Riba*, some studies argue these may be inferred [see, for instance, Moore (1997), Siddiqi (2004) and Iqbal and Molyneux (2005)]. Moore (1997), for example, observes that *Riba* contradicts the principles of profit/loss sharing which aims to create a proper balance between the lender and the borrower. Siddiqi (2004) provides other reasons for the prohibition of *Riba*. First, *Riba* is a form of social corruption referred to by Arabic scholars as *Fasad*. Siddiqi (2004, p. 42) translates the following from the *Holy Quran* (30:38-41):

That which you give in usury in order that it may increase in other people's property has no increase with Allah; but that which you give in charity, seeking Allah's countenance, has increase manifold. Allah is He Who created you and then sustained

you, then causes you to die, then gives life for you again. Is there any of your (so called) partners (of Allah) that does aught of that? Praised and exalted be He above what they associate with him. Corruption does appear on land and sea because of (the evil) which men's hands have done, that He may make them taste a part of that which they have done, in order that they may return.

Here the giving or taking usury can be related to the appearance of corruption, which in a society results from men's wicked behaviours on earth. Second, *Riba* implies the wrongful appropriation of other people's property without justification. In other words, usury or interest is a property right claimed outside the lawful framework of identified property rights that create a balance between rich and poor people. In Islam, people who affect the property rights of others will face punishment from Allah at the day of the judgment. The *Holy Quran* (4:161) supports this contention: "And of their taking usury when they were forbidden it, and of their devouring people's wealth by false pretences. We have prepared for those of them who disbelieve a painful doom". Third, *Riba* decreases the resources of states through a negative effect on the growth of economies. The *Holy Quran* (2: 276) states "Allah has blighted usury and made almsgiving fruitful. Allah loves not the impious and guilty" (Siddiqi 2004, p.36). This verse suggests that the usury or interest creates unfairness. On the other hand, a better way to create positive growth in the economy is by giving to charities or providing interest-free loans.

Fourth, *Riba* demeans and diminishes the humanity of individuals. Siddiqi (2004, p. 43) inferred this meaning from Allah that those who receive or pay usury are affected by the touch of the Evil (2:275). Persons so affected become mad with greed because they need to obtain more and more interest and usury without stopping. Fifth, *Riba* leads to money being made from money: an unacceptable practice in Islamic finance. In Islam, money is an exchange instrument that has no value in itself. It is argued that those who place their money as a deposit in a bank or lend it to gain interest earn money without effort or risk. According to *Sharia*, people should be productive and useful, but only by investing their money in useful trade and economic enterprise (Siddiqi 2004).

Finally, the most essential reason for the prohibition of *Riba* is that it is unfair in that it affects borrowers and lenders alike. Iqbal and Molyneux (2005) argue that the borrower must pay interest and repay the capital, as well as bearing any losses from the use of these funds (a form of 'double charging': that is, charging for both the funds and the use of the funds). In addition, *Riba* is also regarded as being unjust to the lender. This is because the real rate of

interest may become negative if, say, the rate of inflation is higher than rate of interest. Therefore, lenders who wish to earn a profit from lending money could make a loss. Once again the loss incurred would be unrelated to the actual use of the funds.

4.2 Prohibition of *Gharar* (risk and uncertainty)

The second significant prohibition in Islamic finance is *Gharar*, generally translated as risk, hazard or uncertainty. Al-Dareer (1997, p.10) defines *Gharar* in jurisprudential terms under three headings:

First, *Gharar* applies exclusively to cases of doubtfulness or uncertainty, as in the case of not knowing whether something will take place or not. The definition by Ibn Abidin is a case in point: *Gharar* is uncertainty over the existence of the subject matter of sale. A second view holds that *Gharar* applies only to the unknown, to the exclusion of the doubtful. This view is adopted by the Zahiri School. Thus, according to Ibn Hazm, *Gharar* in sales occurs when the purchaser does not know what he has bought and the seller does not know what he has sold. The third view is a combination of the two categories above; *Gharar* here covers both of the unknown and the doubtful, as exemplified by the definition proposed by Al-Sarakhsy who states that *Gharar* obtains where consequences are concealed. This is the view favoured by most scholars.

More simply, El-Gamal (2000, p.7) defines *Garar* as "... the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling". However, Al-Saati (2003) counters that there is no agreement among Muslim jurists about the degree of uncertainty in commercial transactions to be considered as *Gharar*. Iqbal and Molyneux (2005, p.14), for instance, suggest that "*Gharar* refers to acts and conditions in exchange contracts, the full implications of which are not clearly known to the parties. This is something very similar to asymmetric information". Metwally (2006) also argues that *Gharar* are speculative transactions which are harmful to society.

Metwally (2006), Iqbal and Molyneux (2005), Al-Saati (2003) and El-Gamal (2000) agree upon some basic features of *Gharar* in exchange contracts. To start with, *Gharar* can be any contract for sale or purchase that includes uncertainty in genus, species, quantity of the object, price, time of payment in deferred sales, existence of object, and identity of object. Although there is no explicit statement known in the *Quran* forbidding *Gharar*, it is well-accepted that it is forbidden. For example, Al-Saati (2003, p. 7) has inferred the prohibition of *Gharar* from two Quranic verses (2:188; 4:29) as follows: "And do not eat up your property among yourselves for vanities, nor use it as bait for the judges". "O ye Who believe! Eat not up your property among yourselves in vanities; but let these be amongst you traffic and trade by

mutual good will". In addition, he adds that there is a consensus between some scholars about the meaning of *Al-batil* (vanity) which is *Gharar*.

However, there are many *Hadiths* (traditions) banning *Gharar* sales narrated by Muslims. For instance, "Ahmad and Ibn Majah narrated on the authority of Abu-said Al-khudriy: Muhammad has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver" (El-Gamal (2000, p.7). Metwally (2006, p.15) also argues that the Muhammad said "One who imports from outside and sells at the market rate for his maintenance is blessed, while he who withholds transactions in view of estimated dearness in future, is thrown away from God's pleasure".

4.3 Prohibition of *Maysir* (gambling and other games of chance)

Maysir is regarded by most Islamic scholars as gambling or any games of chance (including lotteries, lotto, casino-type games and betting on the outcomes of animal races). Together, these share a desire for obtaining return through deliberate risk-taking (Al-Saati 2003). Both games of chance and gambling are banned by *Sharia*. Iqbal and Molyneux (2005, p.15) provide evidence from the *Holy Quran* (5:90) as follows: "O, you who believe! Intoxicants (all kinds of alcoholic drinks), and gambling, and *Al-Ansab* (animals that are sacrificed in the name of idols on their altars) and *Al-Azlam* (arrows thrown for seeking luck or decision) are an abomination of Satan's handiwork. So avoid that (abomination) in order that you may be successful".

Further, Metwally (2006, p.15) argues that "*The Holy Quran* says (chapter 2, verse 219); they question thee about alcoholic drinks and games of chance (speculation). Say: in this is great sin and some utility for men; but its sin is greater than its usefulness". Even though there is a general consensus among Muslims who believe in the tenets of *Sharia* and therefore do not question the reasons for forbidding the *Maysir*, Iqbal and Molyneux (2005) provide some reasons underlying the prohibition of games of chance and gambling. They argue that because of the high risk available in these types of transactions, some people win a large amount of money, but others suffer from a loss of their money, and sometimes face bankruptcy. This could lead to greater financial and societal problems. In addition, these games and gambling are unnecessary for society because they cannot add any surplus to societal wealth.

4.4 Prohibition of using or dealing in forbidden commodities

Islamic finance encourages people to invest their money, but this general encouragement is expected to comply with the rules set by *Sharia*. According to Islamic doctrine, some commodities, such as alcohol, drugs, and pork, are strictly forbidden. Thus, people should not use or exchange items banned by the *Holy Quran*. Lewis and Algaoud (2001) have pointed out that neither individuals or institutions can trade or finance enterprises that deal in forbidden items. The aim of *Sharia* in this regard is to promote 'ethical' investments that again do not affect people and society adversely through the violation of religious prohibitions.

4.5 The sharing of business profits and risks

Islamic finance encourages people to invest their money effectively without any injustice for those who are either lenders or borrowers. According to this principle, lenders should share with borrowers the profits or losses from the funded enterprise. Usually this is taken as they should equally distribute the risk of their business, consistent with their sharing of the capital contributed to the enterprise. Kahf and Khan (1993) explain this in two parts: a profit-sharing principle and a profit/loss sharing principle. According to the former, both the owner of the capital and the entrepreneur share in the profits of the enterprise, referred to as *Mudarabah*. In this method of finance, the owner of the funds provides capital to an entrepreneur who provides experience and effort as a working partner. However, they only share the profits of the business. In the case of a loss, the owner of the funds bears the risks of loss and the entrepreneur loses their time and effort. The latter principle is a full partnership in capital and management, as well as in the profit and loss, of a particular enterprise. For instance, the *Musarakah* (full partnership) in Islamic finance allows partners to share specific percentages of capital in their working partnership and any profit/loss earned from the enterprise is divided according to the proportion of capital invested.

4.6 Paying and collecting of *Zakah* (payments to the poor)

Ahmed (2004) defines *Zakah* as "...a due right on specific items of assets or properties, in specific percentages with considerations of the passage of a year and satisfaction of the condition of *nisab*". *Nisab* is the minimum amount of assets that is *zakatable* according to *Sharia* that considers *Zakah* as one of the five pillars of Islam identified by the *Holy Quran*. Metwally (2006, p.14) provides a comprehensive definition as follows:

Zakah is the cornerstone of the financial structure in an Islamic economy. It is one of the fundamental tenets of Islam. Literally, *Zakah* means purification. Technically it means a contribution of a proportion of wealth for the use of the poor and needy as sanctification for the remainder of the property. Hence, in modern terminology, *Zakah* is a tax collected from the relatively richer Muslims and distributed (mainly) among the poorer Muslims.

The *Holy Quran* in a number of instances includes references to "...keep up prayer and pay *Zakah*" (Metwally 2006, p.14). Sometimes, *Zakah* is also referred to as *Sadqa* (charity or alms) in verses of the *Holy Quran*. For instance, "...alms are for the poor, and the needy, and those employed to administer the funds, and those whose hearts have been reconciled to truth, and those in debt and those in the cause of Allah, and the Wayfarer" (9:60 cited in Metwally 2006). This verse indicates the categories of needs to which *Zakah* could be paid. Even though there is no doubt in Islamic teaching that Allah created people equally, it is equally recognised that people live in income inequality, with many individuals unable to obtain enough money to meet their needs. Paying *Zakah* represents a financial way to support those who suffer from poverty or those who become debtors without having the ability to repay their debts.

Clearly, Islam also makes it mandatory for the rich to support the poor and needy. The *Holy Quran* states: "And those in whose wealth there is a recognized right, for the beggar who asks and for the unlucky who has lost his wealth" (70:24-25 cited in Ahmed 2004, p 21). Interestingly, the amount of *Zakah* should not deplete the resources of the rich. Although, there are no specific verses from the *Holy Quran* that observe the correct amount of the *zakah*, Muhammad indicated a number of ratios for different assets. For example, for all 'idle assets' (like gold, silver and money) 2.5 percent should be imposed (Metwally 2006). In Ahmad's (2004) definition this percentage is payable annually. This effective approach could achieve many goals at the same time that have important social and economic objectives such as reductions in poverty, crime and the creation of social and economic equity. However, to achieve these goals efficiently, the collection and distribution of *Zakah* requires special administration that provides good management for the funds. Peerzade (2005) claims that *Zakah* that is payed should be transferred to the public coffers for spending. One implication is that governments should institutionalize *Zakah* to ensure the minimisation of poverty.

4.7 *Takaful* (Islamic insurance)

The commercial insurance industry is one of the most widespread financial industries (Billah 2001b). However, most Muslim jurists argue that commercial insurance involves *Gharar*, and is thus prohibited. According to El-Gamal (2000), this point of view arises because commercial insurance contracts have a substantial *Gharar* component that affects the outcome of an insurance contract. In brief, the insurance contract represents a sale contract and the amount of the insurance which may be collected by the insurer and the insured is potentially unknown. It is the unknown payoffs implicit in an insurance contract that leads to *Gharar*. One means of overcoming this is Islamic insurance or *Takaful*. This is a mutual self-help scheme between those who wish to support each other in difficult times. El-Gamal (2000) introduces Islamic insurance as a cooperative insurance scheme that could be established with a pool of funds by a specific group of people who do not aim to obtain profit from the pool, but may invest its funds in permissible activities in Islam to increase the fund's wealth. In turn, the *Takaful* provides members with financial help in the instance of specific events.

Muslim scholars derived *Takaful* from the *Holy Quran* where it says: "Help you one another in righteousness and piety, but help you not one another in sin and rancour" (5:2 cited in Billah 2001a, p. 4). Billah (2001a, p. 2) further supports the permissibility of *Takaful* by citing two traditions from the *Sunna* as follows:

Narrated by Anas bin Malik, the Holy prophet told a Bedwin Arab who left his camel untied trusting to the will of Allah said: Tie the camel first and then leave it to Allah".

Narrated by Abn Huraira, the Holy prophet said: whosoever removes a worldly hardship from a believer, Allah will remove from him one of the hardships of the day of the judgment. Whosoever alleviates from one, Allah will alleviate his lot in this world and the next.

Maysami and Williams (2006) also argue that *Takaful* is a permissible tool which complies with the principle of joint guarantee in *Sharia* encouraging mutual self-help. However, Islamic insurance should help policyholders only, not for the earning of profits, although using the funds in permissible activities to increase its wealth is acceptable. Consequently, Islamic insurance institutions have been established in Muslim and non-Muslim countries to offer its services for those in need of financial assistance. Metwally (2006) has observed that the *Takaful* funds can potentially be administrated by an Islamic bank which collects *Takaful* insurance premiums, provide financial assistances for policyholders, and invests these funds

in permissible enterprises according to the wishes of the participants and in compliance with *Sharia*.

5. Islamic methods of finance

As discussed in the previous section, Islamic finance is designed according to fundamental principles that comply with *Sharia*. This section focuses on the most common Islamic finance methods as practiced by Islamic banks and other financial institutions. The principal instruments take the following forms: (i) *Mudarabah*, the provision of capital in a partial-equity partnership; (ii) *Musharakah*, full equity partnerships, (iii) *Murabaha*, an instrument used for financing the purchase of goods; (iv) *Bai muajjal*, deferred payments on products; (v) *Bai Salam*, advance sale contracts; (vi) *Istisna*, or manufacturing contracts; (vii) *Ijarah*, lease financing; and (viii) *Quard Hassan*, a system of benevolent loans..

5.1 *Mudarabah* (capital trusts)

The *Mudarabah* (or capital trust) is a form of profit or loss (equity-based) sharing used by tradesmen in Mecca before Islam. The best evidence for its existence is Muhammad employed *Mudarabah* with a rich woman named Khadijah about fifteen years prior to the establishment of Islam (Abdul-Gafoor 2006). *Mudaraba*, in jurisprudence, is "...a mode of financing through which the bank (the owner of the capital or *rabb-al-mal*) provides capital finance for a specific venture indicated by the customer (the entrepreneur or *mudarib*)" (Obaidullah 2005, p.57). In other words, *Mudarabah* is a contract between two parties: an investor (individual or bank) who provides a second party, the entrepreneur, with financial resources to finance a particular enterprise. Profits are then shared between the two parties (*rabb-al-mal and mudarib*) according to some pre-agreed ratio, but if there are losses the investor bears all financial losses and the entrepreneur the operating losses; principally the opportunity cost of their own efforts. The flows of funds are depicted in Figure 1. This distribution of profits and losses is an equitable approach that conforms to Islamic principles.

In an alternative form, the *rabb-al-mal* is a customer who deposits capital in a bank, representing the *mudarib*, to invest according to *Mudarabah*. In addition, Aljarhi and Iqbal (2001) suggest that *Mudarabah* deposits could be compounded in a public pool for investment, which is a permissible way for the manager (bank) to mix *Mudarabah* deposits with its own funds. In this case, profits would again be distributed according to an agreed formula, but losses once again remain the liability of the capital providers as shown in Figure

2. Although *Mudarabah* may be applied in various economic activities, the majority of Islamic jurists and scholars hold the view that *Mudarabah* contracts are only really suitable for commercial activities.

5.2 *Musharakah* (full partnerships)

Musharakah (or full partnership) is "...an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labour and management as a general rule" (Iqbal and Molyneux 2005, p. 20). The profits and losses that flow from the *Musharakah* are again shared among the parties on a pre-agreed ratio. Generally, *Musharakah* is most suited for financing private or public companies and project financing. In the context of Islamic banking, *Musharakah* is described as a joint venture between an Islamic bank and a customer or business firm for certain operations. The Islamic bank can potentially act as the fund provider to finance industry, trade and almost all legal enterprises through either equity investment or direct participation.

Lewis and Algaoud (2001) suggest that *Musharakah* contracts can be established in one of two ways. The first way of these is a permanent contract which ensures for its parties (the investor, bank and entrepreneur) an equitable share in the annual profit/loss on pre-agreed terms. This kind of permanent contract holds constant for a limited or unlimited period according to the original agreement as shown in Figure 3. The second type of *Musharakah* is a diminishing contract preferred by bankers because it allows the bank to reduce its share of equity each year and receive periodic profits based on the reducing equity balance. In this form, the equity share of the customer in the capital of enterprise increases over time until he or she becomes the sole owner of the enterprise. The relationships are depicted in Figure 4. As shown, *musharakah* has many advantages that provide equal benefits for all parties and there is a consensus among Islamic scholars of its validity under *Sharia*. However, El-Gamal (2000) has observed that most of the parties in *Musharakah* contracts usually require the help of legal experts to ensure that any potential *Riba* or *Gharar* is carefully avoided.

5.3 *Murabaha* (mark-ups on sale)

Murabaha is an Islamic instrument for buying and reselling the purchase or import of capital goods and other commodities by institutions, including banks and firms. Under the *Murabaha* contract, the customer provides the bank with the specifications and prices of the goods to be purchased or imported. The Islamic bank studies the application and collects information

about the specifications and prices of the goods, focusing especially on the price and conditions for payment. When the bank and its client agree on the terms of the deal, the bank purchases the goods or commodities and resells them to the customer. The profit that accrues to the bank is mutually agreed upon as a profit margin (mark-up) on the cost of purchase (Metwally 2006). The fundamental principles attached to *Murabaha* can be summarised as follows: (i) goods must be classified, clearly identified according to commonly accepted standards and must exist at the time of sale; (ii) goods for sale must be in the ownership of the bank at the time of sale; (iii) the cost price must be known at the time of sale and this should be declared to the client. This is especially the case when the bank succeeds in obtaining a discount where the profit margin is calculated on the net purchase price (this means discounts also provide benefits to the client); and (iv) the time of delivery of the goods and the time of payment must be specified. (Obaidullah 2005; Iqbal and Molyneux 2005; Lewis and Algaoud 2001; El-Gamal 2000; Kahf 1997)

In fact, the *Murabaha* contract is merely a two-party buying and selling contract between bank and customer involving no financial intermediation or financing. In other words, the bank offers this service to clients who should pay the cost of the goods plus a profit margin to the bank immediately following receipt. In addition, the client can pay for the goods and the bank's profit margin by deferred instalments or a deferred lump sum without an increase over the original value. This type of contract is referred to as *Bai muajjall-Murabbah* or *Bai bithaman ajjal* (Obaidullah 2005).

5.4 *Bai muajjall* (deferred payments)

The term *Bai muajjall* is a sale on a deferred payment basis that allows business or individuals to receive products now and pay for their value in the future. Lewis and Algaoud (2001) consider that credit sales could include *Bai muajjall-Murabaha* since all deferred payments are in instalments or a lump sum. However, there is a significant difference between *Bai muajjall* and *Bai muajjall-Murabaha* in that in any kind of *Murabaha* the buyer must know the cost price of the commodity as a prerequisite to an acceptable contract (Obaidullah 2005). There is a consensus among Islamic jurists and scholars about the permissibility of credit sales (*Bai muajjall*) as a form of finance that includes no *Riba*. El-Gamal (2000), for example, suggests Islamic jurists have generally permitted sales where the price has increased with deferment, but have forbidden sales where the amount of the debt increased with deferment.

For example, in a credit sale both the buyer and seller agree to defer the sale price until payable in one month and increase the sale price to cover. This sort of agreement would be permissible. However, it is not permitted if they defer the lending that proceeds from the sale now for one month and increase the amount by interest. The first example is a trading transaction accepted by the *Holy Quran* and the *Sunna*, but the second example is a lending transaction involving *Riba*.

5.5 Bai salam (prepaid purchases)

Bai salam is a form of advance payment or forward buying defined by Iqbal and Molyneux (2005, p. 25) as follows: “*Salam* is a sale contract in which the price is paid in advance at the time of contracting against delivery of the purchased goods/services at a specified future date”. Even though the sale and purchase of nonexistent goods are prohibited because of *Gharar*, the *Bai salam* is a permissible activity that is adopted by the *Sunna* to facilitate certain activities in agriculture and industry. As one example, El-Gamal (2000, p. 17) cites the following *Hadith* narrated on the authority of Ibn Abbas:

The Messenger of Allah came to *Madinah* and found its inhabitants entering *salam* contracts (with the price paid in advance) in fruits for one, two, and three years. He said: Whoever enters into a *salam* contract, let him specify a known volume or weight, and a known term of deferment.

In addition, the Messenger of Allah said: “Whoever enters into *Salaf*, should stipulate a determined weight and measurement, and a determined date of delivery”, the word (*Salaf*) of the *Hadith* has meaning of *salam* (cited in Al-Masri (2003, p.29). The main legal requirements for *Bai salam* contracts to be permissible are: (i) the commodities sold should not be available at the time of contracting; (ii) the quality and quantity of goods must be known; (iii) the date and place of delivery for these commodities should be defined; and (iv) the purchase cost price should be paid completely at the time of the contract.

5.6 Istisna (manufacturing contracts)

Istisna is a relatively new method in Islamic banking, defined as a manufacturing contract which allows one party to obtain industrial goods with either an upfront cash payment and deferred delivery or deferred payment and delivery. It has been translated by El-Gamal (2000, p 17) as a “...commission to manufacture” usually used to cover work progress in the manufacturing and building industries. This method has a significant advantage in that the cost price is prepaid or is deferred as instalments to create a product at a lower price than the

cost of buying the complete product or building. In the context of Islamic banking, individuals or firms request their bank to facilitate a contract of production for a good, and the bank concludes an *Istisna* contract with a third party (the manufacturer) to produce and deliver the specific item under particular requirements (Lewis and Algaoud 2001). The permissibility of *Istisna* is adopted by the use of analogy (*Qyas*) among most Muslim jurists with the permissibility of *Bai salam* (El-Gamal 2000). However, *Istisna* differs in many ways from *Bai aslam*. For example, the *Istisna*'s subject is usually a commodity or item which demands manufacturing, the payment in *Istisna* could be a lump sum or instalments which can be deferred; and the time of delivery in an *Istisna* contract could be unknown (Iqbal and Molyneux 2005).

5.7 Ijarah (lease financing)

Ijarah is the reward or recompense that proceeds from a rental contract between two parties, where the lessor (the owner of the asset) leases capital asset to the lessee (the user of the asset). *Ijarah* literally means "...to give something on rent" (Lewis and Algaoud 2001). The use of *Ijarah* was known before Islam and is evidenced by the *Holy Quran* and the *Sunna*. For example, (28:26-27 cited in El-Gamal 2000 p, 13)

...Said one of them: O father, hire him on wages, for truly the best to employ is a strong and trust worthy man. He said: I intend to wed one of my daughters to you, on condition that you work for me for eight years, and if you complete ten full years, that will be a grace from you.

It is also adopted in the following *Hadith* narrated by Ahmad Abu Dawud and Al-Nasai cited in El-Gamal (2000 p. 13):

The farmers during the time of the Prophet used to pay rent for the land in water and seeds. He forbade them from doing that, and ordered them to use gold and silver (money) to pay the rent.

In Islamic finance, there are two forms of leasing: (1) direct leasing finance (*Ijarah*), whereby the lessor (either an individual or a firm) allows the lessee to use capital assets owned by the lessor for a specified period of time ranging from a few days to years depending on the type of asset. In return, the lessee pays the rental fee monthly or annually. However, the ownership of the capital assets cannot transfer to the lessee in this type of leasing (as in finance leases) and insurance on the capital assets remains the responsibility of the lessor (Zaher and Hassan 2001). In contemporary Islamic banking, *Ijarah* has been adapted to provide a form of hire-purchase (*Ijarah wa-Iqtina*), whereby an institution or individual customer requests the bank

to purchase equipment with the intention of leasing it to the customer. In turn, the Islamic bank rents the asset to the client who pays a certain fixed rent and promises to purchase the asset within a specified period to transfer ownership from the bank to the customer (Al-Jarhi and Iqbal 2001). Furthermore, this could be transformed as a decreasing-value lease that allows the client to pay an instalment of the value of the asset plus its rent each period to reduce the lessor's share of ownership until the lessee becomes the owner (Metwally 2006).

5.8 *Quard Hassan* (benevolent loans)

The act of lending money is not forbidden in *Sharia*, only *Riba* is prohibited in the process of lending. *Quard Hassan* is a benevolent loan without interest to assist the needy in an attempt to alleviate hardship. Consequently, individuals and firms may lend money on an interest-free basis to any number of beneficiaries for many purposes, including expenses relating to education and marriage. The amount paid by the lender is considered an interest-free loan from the time of payment until the date of the settlement. Metwally (2006) and Lewis and Algaoud (2001) add that the borrower's payment of any amount over and above the principal to the lender is permissible so long as it is at the borrower's discretion. It is also permissible for the lender to request assets as collateral and charge administrative expenses on the loan (Obaidullah 2005).

6. Islamic Banking

As discussed earlier, Islamic banking is a relatively recent phenomenon dating only from the early 1970s. Al-Jarhi and Iqbal (2001, p. 23) define an Islamic bank as follows:

An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilizes funds on the basis of *Mudarabah* contract. It can also accept demand deposits which are treated as interest-free loans from the clients to the bank, and which are guaranteed. On the assets side, it advances funds on a profit-and-loss sharing or a debt-creating basis, in accordance with the principles of the *Sharia*. It plays the role of an investment manager for the owners of time deposits, usually called investment deposits. In addition, equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations. An Islamic bank shares its net earnings with its depositors in a way that depends on the size and date-to-maturity of each deposit. Depositors must be informed beforehand of the formula used for sharing the net earning with the bank.

Clearly, an Islamic banking system can only be made operational by incorporating two fundamental principles: namely, the prohibition of interest and the introduction of profit-and-loss sharing methods with strict conformance to *Sharia*.

6.1 A brief review of developments in Islamic banking

The first Islamic social bank was established in Pakistan in the 1950s to help poor farmers. At about the same time, Malaysian Muslims established funds that helped pilgrims gather their savings for the pilgrimage to *Makkah* (Mecca) The Mit Ghamer savings bank in Egypt was established in 1963 and the Nasser Social Bank in 1971 (Lewis and Algaoud 2001). The public sector promotion of Islamic banking began with the Islamic Development Bank in 1975 (Iqbal and Molyneux 2005). Islamic banking spread dramatically during the final decades of the last century. Currently, there are more than 200 Islamic banks and financial institutions operating worldwide with over \$200 billion in assets (Wilson 2002, p. 373). In fact, the number of Islamic banks' is currently increasing by about 15 percent annually (Taylor 2003, p.400).

The overriding objective of Islamic banks is to promote economic development in Muslim societies by mobilizing financial resources in accordance with *Sharia*. However, there are many other objectives that have also been suggested. Haron (1995) finds that Islamic banking objectives also potentially include the following: (i) provide contemporary Islamic financial services to people and protecting them from financial deals that involve *Riba*; (ii) develop banking services and products based on *Sharia*; (iii) create acceptable yields as legitimate profits to the shareholders and investors deposits; (iv) achieve moral consciousness side-by-side with profitable transactions; and (v) serve Muslims and other nations through benevolent lending to promote fraternal bonding.

6.2 Types and examples of Islamic banks

While it is possible to classify Islamic banks according to their ownership structures – state-owned, jointly-owned and privately-owned – an alternative classification based on their purpose is also found in the literature. This taxonomy of Islamic banking includes Islamic social banks, development banks, commercial banks and holding banks.

First, the main feature of an Islamic social bank is its emphasis on objectives that embrace the mobilization of savings between individual consumers. This is generally considered more important than an increase in bank profits. This kind of bank also often offers other social

services such as the collection and distribution of *Zakah* and the provision of interest-free loans. An example is the Mit Ghamer savings bank in Egypt. Second, Islamic development banks usually aim to enhance and promote social and economic development in the state more broadly. This can be an institution that also aims to finance public sector development projects in other (often Muslim) countries. The concept is accepted to have started in Saudi Arabia with the creation of the Islamic Development Bank in 1975 by the governments of Saudi Arabia, Kuwait, Libya, Turkey, the United Arab Emirates, Iran and Egypt. This particular institution aims to foster economic development, social progress and economic relations of member countries and Muslim communities in conformity with the principles of *Sharia*.

Third, an Islamic commercial bank is defined as a financial institution that accepts deposits from depositors and makes them available to entrepreneurs either at mark-up or via profit-and-loss sharing methods of finance. These banks usually engage in all types of commercial activities and may invest directly in across sectors in the economy. Most modern Islamic banks are examples of commercial banks that offer deposit accounts and financing instruments derived from Islamic principles. Examples include Bank Muamalat (Indonesia), Islamic Bank Brunei, Bahrain Islamic Bank, Bank Melli Iran, Al-Baraka Bank Lebanon, Bank Al-Jazeera (Saudi Arabia), Abu Dhabi Islamic Bank, Al-Amanah Islamic Bank (Philippines), Grindlays Modaraba (Pakistan) and Islamic Bank of Britain. Finally, an Islamic holding bank is a holding institution established to assist existing Islamic banks to identify investment opportunities in the international market along with possible financing projects in Muslim states. Currently, there are three groups of Islamic holding banks: the Islamic Banking System International, the Dar al-mal al Islami Trust and the Al-Baraka Group.

6.3 Islamic Banking Operations

Islamic banking operations have developed over the time to modify the operations of conventional banks to meeting individual and firm needs under *Sharia*. Islamic banks depend on shareholders' capital as well as deposits from depositors and funds invested by investors. The sources of Islamic banks and their uses of these funds have been investigated in a number of studies, particularly Abdul-Gafoor (2003), Alam (2000) and Haron (1995).

The three main types of Islamic deposit accounts are as follows. First, Islamic current accounts are a service offered to depositors to process bank transfers and pay cheques through

existing transfer and settlement systems. These accounts are payable on demand and no interest or profits are paid to depositors. Current accounts can also be held in a foreign currency to facilitate international trade. Second, as with comparable products offered by conventional banks, Islamic savings accounts offer flexible deposits, withdrawal on demand and a guarantee of capital. However, unlike conventional bank savings accounts, interest is forbidden on account balances. Depositors can, however, obtain benefits in the form of ‘prizes’ that depend, in part, on the value of the deposit and the bank’s profitability. These services are also often offered fee-free to depositors.

Third, Islamic investment deposit accounts are designed for customers who wish to invest their funds using profit/loss sharing principles. In practice, there are two main types of investment accounts, specified and unspecified. In the first category, the depositor empowers the bank to invest funds in conditional or limited investments: that is, specific enterprises or sectors. In the second category, the depositor gives the bank an unconditional authorisation to invest the deposited sum according to the wishes of the bank in any suitable project. Investment accounts are usually administrated under the principles of *Mudarabah* and *Musharakah* that establish the bank as the entrepreneur (*mudarib*) or a participant and the depositor as an investor or a participant. Within this, they share profits and losses according to some pre-agreed ratio.

In the Islamic banking system the using of offered funds is rather more complicated. Unlike conventional banks, in Islamic banks money should not earn returns without evidence of a direct collaboration between capital and effort. Therefore, Islamic banks cannot act as a financial intermediary in the strictest sense since this would involve accepting deposits from individuals or firms and lending them to borrowers who are also individuals or firms. However, according to the principles of Islamic finance there are many financing or participating instruments that can be used to meet financial needs in the market and to provide short, medium and long term funds. These include *Mudarabah*, *Musharakah*, *Murabaha*, *Bai muajjall*, *Bai Salam*, *Istisna*, *Ijarah* and *Quard Hassan*.

Outside retail services, Islamic banks offer many similar services to conventional banks in the form of performance bonds, letters of guarantee, letters of credit, travellers’ cheques, money transfers, foreign exchange transactions and safe deposits. In these situations, the Islamic bank can collect a service or administration fee corresponding to the expense incurred on the

service rendered under *Sharia*. Moreover, the bank can charge commission when transactions involves the sale and purchase of metals (such as gold) on behalf of a customer because the bank serves as an agent. This is likewise permitted under *Sharia*.

7. Conclusion

Islamic finance is defined as a financial service principally implemented to comply with the main tenets of *Sharia* (or Islamic law). In turn, the main sources of *Sharia* are the *Holy Quran*, *Hadith*, *Sunna*, *Ijma*, *Qiyas* and *Ijtihad*. The *Holy Quran* is the book of revelation given to the Prophet Muhammad; *Hadith* is the narrative relating the deeds and utterances of Muhammad; *Sunna* refers to the habitual practice and behaviour of Muhammad during his life; *Ijma* is the consensus among religion scholars about specific issues not envisaged in either the *Holy Quran* or the *Sunna*; *Qiyas* is the use of deduction by analogy to provide an opinion on a case not referred to in the *Quran* or the *Sunna* in comparison with another case referred to in the *Quran* and the *Sunna*; and *Ijtihad* represents a jurists' independent reasoning relating to the applicability of certain *Sharia* rules on cases not mentioned in ether the *Quran* or the *Sunna*.

The main principles of Islamic finance include the prohibition of *Riba* and the removal of debt-based financing from the economy, the prohibition of *Gharar*, encompassing the full disclosure of information and removal of any asymmetrical information in a contract, the exclusion of financing and dealing in sinful and socially irresponsible activities and commodities such as gambling, casinos, production of alcohol, etc., risk-sharing, the provider of financial funds and the entrepreneur share business risk in return for shares of profits and losses, materiality, a financial transaction needs to have a 'material finality', that is a direct or indirect link to a real economic transaction and justice, a financial transaction should not lead to the exploitation of any party to the transaction.

Employing these principles, the main financial instruments in Islamic finance are *Mudarabah*, the provision of capital in a partial-equity partnership, *Musharakah*, full equity partnerships, *Murabaha*, an instrument for financing the purchase of goods, *Bai muajjall*, deferred payments on products, *Bai Salam*, advance sale contracts, *Istisna*, or manufacturing contracts, *Ijarah*, lease financing and *Quard Hassan*, the system of benevolent loans.

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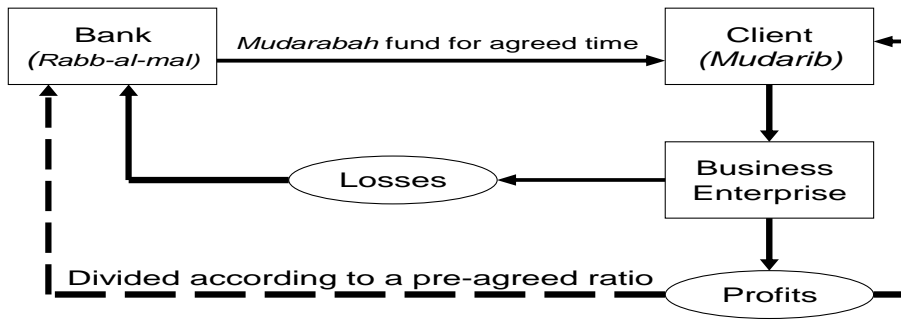


Figure 1: Bank Finances *Mudarabah* for Client

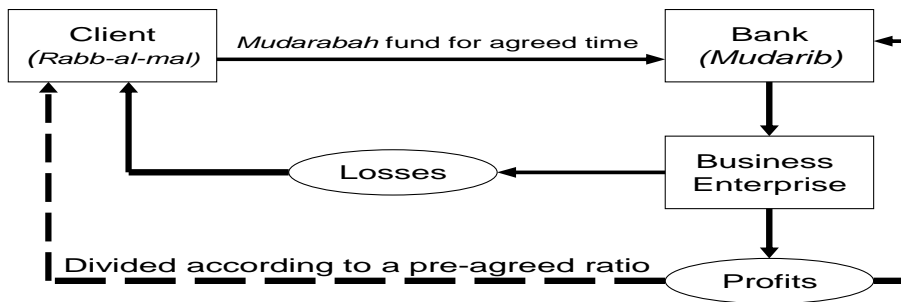


Figure 2: Client Finances *Mudarabah* for Bank

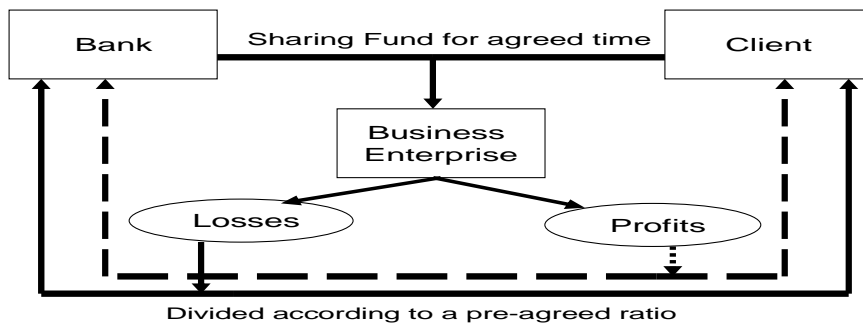


Figure 3: *Musharakah* Between Bank and Client

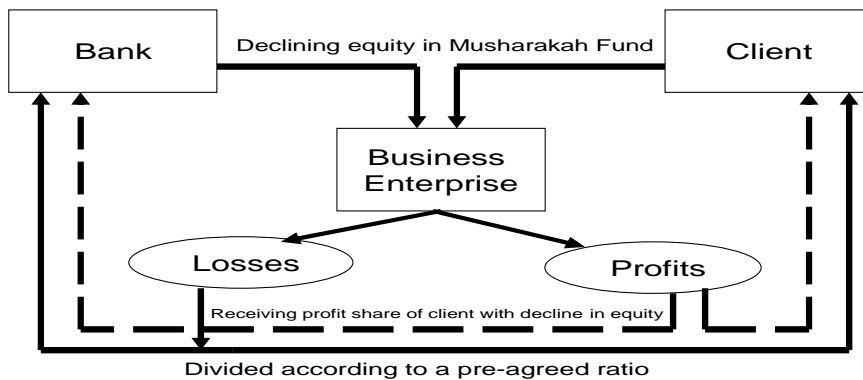


Figure 4: Declining *Musharakah* Between Bank and Client