Islamic Banking and Finance in South East Asia (Part 1)
– An Overview
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Intro

The key feature, or principle, that distinguishes Islamic banking from any conventional banking is the rejection of interest-based financial transactions. The prohibition of interest is derived from Islamic law, which is enshrined in the Quran. Since the advent of Islam dates back to the seventh century, the application of ethical principles that were first established fourteen centuries ago to modern situations and circumstances can be a complex matter. Naturally, ancient texts are mute on such matters as derivatives and stock options, which means that modern-day Islamic scholars must extrapolate.

The dramatic growth of Islamic finance over the last two decades is one of the more striking phenomena in international banking. Twenty years ago there were a handful of Islamic financial institutions; today there are over 187 Islamic banks worldwide, and major international banks such as Citibank and HSBC have established their own Islamic finance arms.[1] In 1997, the total assets of Islamic financial institutions were estimated at over US$100 billion,[2] compared with US$5 billion in 1985[3], and currently the total assets in the global Islamic banking industry stand at over US$260 billion, with annual growth rate of 23.5 percent.[4] Moreover, this growth is not limited to Islamic countries such as Pakistan and the Gulf States. The Islamic banking sector has gained a toehold in the United Kingdom, United States and Western Europe, with a number of non-bank Islamic finance service entities presently in operation. At least three Islamic leasing companies are currently operating in the United States and the United Bank of Kuwait has recently begun to offer retail Islamic mortgages in the US. At the same time, US and foreign-based multinationals, such as General Electric, Exxon and Royal Dutch Shell have all utilised Islamic financing in recent years.[5] The Muslim Community Co-operative Australia (MCCA) which was established in February 1989, operates from its head office in Burwood, Victoria. MCCA's activities involve financial dealings and transactions based on Islamic finance principles. Transactions that involve interest are completely excluded from MCCA's activities.[6] In late 2003, a US$100 million Islamic equity fund was launched to invest in private Australian and New Zealand companies with products compatible with Muslim Shari'ah laws.[7]

Shari'ah Law and Islamic Jurisprudence

The key text upon which Shari'ah law is founded is the Quran, that is to say, the Revelations of the Prophet Muhammad, which came from God. In addition to the Quran, there is the *Sunnah*. *Sunnah* means 'a beaten track' and thus an accepted course of conduct. In Islamic thought, it refers to all the acts and sayings of the prophet as well as everything he approved. The Quran and the *Sunnah* together constitute the primary sources of Islamic law, after which there are the secondary sources, comprising the various schools of law, or *madhab* (plural *madhabib*). One of the schools of law is the Shafi'i school. Today followers of the Shafi'i school are found predominantly in South East Asia.

Islamic Commercial Law

Apart from the prohibition regarding receiving and giving interest (*riba*), there are two other activities prohibited by Shari'ah law that have had a significant impact on Islamic finance. They are the ban on gambling (*maysir*) and the prohibition of uncertainty or risk-taking (*gharar*). The prohibition on *maysir* is often used as grounds for the criticism of conventional financial practices such as speculation, conventional insurance and derivatives, while the prohibition of *gharar* can be applied to various types of uncertainty or contingency in a contract.

Since Shari'ah law prohibits interest, direct loans and other forms of lending such as guaranteed investment certificates, are interest-free. Consequently, Islamic financing must rely instead on a kind of joint venture, or mutual participation, between the customer and the Islamic bank, in order to generate profits. To this end, Islamic banking converts existing deposits into *Islamic* investment deposits, whereby the bank acts as agent or trustee (*mudarib*) instead of lender.

For Muslims, loans cannot be made or accepted according to traditional banking methods because this invariably entails the payment and receipt of interest and therefore is not *halah*.[8] Passing over the laws of conventional finance and banking, Islamic banking allows prospective clients to borrow money while still adhering to Shari'ah law through a profit- and loss-sharing scheme of financing. Profit-and-loss-sharing **(**PLS) financing is a form of partnership where partners share profits and losses on the basis of their capital share and effort, and there is no guaranteed rate of return. Islam supports the view that Muslims do not act as nominal creditors in any investment, but are actual partners in the business.[9]

One common form of profit-sharing enterprises (PSE) based on PLS partnerships is the *Mudarabah* or dormant partnership (also called *qirad*).[10] This is a contract whereby one person (the dormant partner) gives funds or property to another on the basis that the "lending" partner will share in the active partner's profits in a *proportion* agreed in advance. They cannot agree on a fixed return since this would amount to *riba*. Equally, if there is a loss, they also share this loss proportionally, but the liability of the person who has provided the capital is limited to the amount of that capital. The dormant partner remains the owner of the capital, but takes no active part in the enterprise. The trader is responsible only for negligence or breach of contract.[11]

Islamic Financial Products

Islamic finance is based on equity, whereas the conventional banking system is debt based. Islam is not against the earning of money, but it prohibits the earning of money through unfair trading practices and other activities that are socially harmful in one way or another, which is why pre-determined interest or *riba* is forbidden.

Islamic banks which have Shari'ah committees made up of senior officials and Islamic scholars to decide whether or not projects are compliant with Shari'ah principles, will not always respond entirely predictably on what is and what is not suitable for funding. This arises from the fact that Shari'ah law is not a codified body of law, but is open to interpretation and always developing with each new ruling.[12]

There are two ways in which one can obtain project financing the *halah* way.

The first is according to the principle of *al-mudarabah* (trustee profit-sharing). Here the bank acts as the ‘provider of capital’ and will offer 100 per cent financing for the relevant project, while the initiator of the project is the ‘entrepreneur’ who will manage the project. The bank does not interfere in the management of the project, but has the right to undertake the follow-up and supervision task. In these circumstances, both parties will agree, through negotiation, on the ratio of the distribution of the profits generated from the project, if any; in the event of the project making a loss, the bank bears all the losses.[13]

The second is according to the principle of *al-musharakah* (joint-venture profit-sharing). In this instance, the bank, together with the initiator of the relevant project, will provide the equity-financing for the project in agreed proportions. All parties, including the bank, have the right to participate in the management of the project, but equally, all parties have the option to waive such right. All parties agree through negotiation on the ratio of distribution of the profits generated from the project, if any. This ratio need not coincide with the ratio of participation in the financing of the project. In the event of a loss in the project, all parties bear the loss in proportion to their share in the financing.

While interest-bearing debt instruments are prohibited in Islam, there are some Islamic contracts which result in debt. They include *istisna’*,[14] *murabaha*,[15] and *ijara*[16] financing. However, there are no effective derivatives of Islamic debt contracts which replicate conventional risk-hedging and leveraging contracts such as swaps, futures and options.

Since insurance involves an unknown risk, the concept of *gharar* has led to the condemnation of some or all types of insurance by Muslim scholars and led to the development of *takaful* (co-operative) insurance in some Muslim countries. *Takaful* refers to a pact or practice among a group of members, called participants, who agree to jointly guarantee themselves against any loss or damage that may fall upon any of them as defined in the pact. In the event of any member, or participant, suffering a loss due to the defined mishap or disaster, he or she would receive a certain sum of money or financial benefit from a fund as defined under the terms of the pact to help meet or mitigate that loss.

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1 DeLorenzo, Yusuf *A Compendium of Legal Opinions on the Operations of Islamic Banks*, Institute of Islamic Banking and Insurance, 1997.
2 Khalili, Sarah “Unlocking Islamic Finance”, *Infrastructure Finance*, April, 1997, p.19
3 Iqbal, Zamir “Islamic Banking Gains Momentum”, *Middle East Executive Reports*, January, 1998.
4 “Assets in Islamic banking industry put at over 260 billion dollars”, ClariNet, www.clari.net, 25 September 2003.
5 Martin, Josh, Islamic Banking Raises Interest, p. 25.
6 Nida'ul Islam, “Principles of Islamic Banking”, www.islam.org.au, November – December 1995.
7 Taylor, Lenore, “Muslim Fund for Australia”, Australian Financial Review, 20 October 2003.
8 *Halah* — Islamically permissible, that which is lawful according to the Shari’ah. Although in absolute terms the same thing cannot be *halah* and *haram* (prohibited), an unclear and/or controversial issue in Islamic jurisprudence may end up with it being considered *halah* by some Islamic scholars and *haram* by others. www.iHilal.com
9 Al Tamimi & Company, *Islamic Finance: A UAE Legal Perspective* from The International Islamic Finance Forum, International Institute of Research, Dubai, March, 2002, p 2.
10 Abdur Rahman i Doi, Shari’ah: The Islamic Law, pp 365-367.
11 Hussain, Jamila, *Islamic Law and Society* (1999, The Federation Press, Sydney) pp 166-167.
12 Cairo Times, “What is Islamic Banking”, Vol. 1, Issue 3, www.cairotimes.com, 3 April 1997.
13 Vogel, Frank E. and Hayes, Samuel L. *Islamic Law and Finance: Religion, Risk and Return*, Kluwer Law International, The Hague, 1998, p 133.

[14] This refers to an agreement to sell to a customer a non-existent asset, which is to be manufactured or built according to the buyer's specifications and is to be delivered on a specified future date at a predetermined selling price.
[15] The customer may approach the bank to provide financing for his working capital requirements in order to purchase stocks and inventories, spares and replacements, or semi-finished goods and raw materials. In this instance, the bank first purchases the desired items, or else appoints the customer as its agent to purchase the required goods on its behalf, and then settles the purchase price from its own funds. The bank subsequently sells the goods to the customer at an agreed price comprising its purchase price and a profit margin, and allows the customer to settle this sale price on a deferred term of 30 days, 60 days, 90 days or any other period as the case may be. On the due date, the customer pays the bank the agreed sale price.
[16] This is usually a financial-lease type of contract applied for leasing of assets with periodic lease rental payments and ending with sale of the assets at nominal price.