

ISLAMIC FINANCIAL SERVICES

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FOREWORD

The Islamic financial services industry has witnessed a frenetic pace of growth during the last decade. While estimates about the size of the industry differ, conservative sources put the total assets of Islamic financial institutions at two hundred and thirty billion US dollars. Islamic financial institutions operate in over seventy-five countries and they are expected to grow at over fifteen percent during the next five years. Notwithstanding the encouraging data, the fact remains that the industry is too small compared to the size of its potential market. The strength that lies in the number of one billion Muslims is yet to be exploited. One of the key impediments to the growth of Islamic finance is lack of awareness among Muslims about the Islamic alternative models of banking, insurance and investments.

Another key area of concern relates to lack of human resources adequately trained in the models and tools of Islamic finance. Islamic financial institutions have generally been recruiting from the pool of conventional bankers and financial professionals, who often find it too comfortable to camouflage conventional products and services as Islamic ones. The unsavory outcome of this is there for all to see. We now find a wide range of products and services, which are Islamic in form but conventional in every other sense. A solution to the above perhaps lies in creating greater awareness among market participants through research, education and training. The depositors, investors, bankers,

insurance professionals, financial analysts, regulators and policy makers need to be told the full story - why conventional financial products and services are not acceptable in *Shariah*; what are the specific elements and features that are unacceptable; what are the Islamic alternative products and services that fulfill similar needs and address similar concerns and finally whether the alternatives are efficient as well.

The present text by Dr Mohammed Obaidullah is a step in this direction. The text spans over all areas of Islamic financial services, such as, commercial banking, insurance, investment banking, fund management, project finance and what have you. In each area, the ideal Islamic alternative model is presented after a careful evaluation of the conventional product. To add spice to the story, the text includes over twenty illustrations from real life. I am sure the text would address a long-felt need, serve as a useful guide and be of immense help to students, researchers, teachers, finance professionals, regulators and policy makers in the area of Islamic finance.

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PREFACE

This is a book about products, processes and mechanisms that *are* in use in the Islamic financial services industry. The text also focuses on how financial products and services *should be* designed and offered in this industry, given the need for full *Shariah* compliance. Instead of presenting facts and figures that quickly become obsolete, the text describes how financial products and processes develop as solutions to problems and as responses to profit opportunities and need for *Shariah* compliance.

The distinctive feature of this book is presentation of the products and services in the form of flow charts and blue prints that facilitate conceptual clarity and greatly simplify the learning process. For each product, the text provides a blue print that helps differentiate between conventional and Islamic products. All sensitive issues related to *Shariah* compliance are presented as “Issues in Product Management”.

The text covers products and services relating to commercial banking, insurance, investment banking & financial engineering, fund management and project finance and is therefore, neatly divided into five parts – each part devoted to one of the relevant sectors (in addition to the introductory part). Each part begins with a discussion of how products and services are conventionally offered in these sectors. This is followed by an evaluation of the same from the standpoint of *Shariah* compliance. Major elements and features that violate the

Shariah are highlighted. Then the Islamic alternative is presented. Since many of the Islamic alternative products and services require a more elaborate discussion, the discussion is extended over subsequent chapters.

The coverage of the text is up-to-date. There are frequent references to real-life practices. The text includes over twenty illustrations of actual products as they are offered to the Muslim investor or depositor community. These are presented as “Concepts in Practice” and appear as box items, distinct from the main contents. The information for the illustrations have been carefully culled from public sources – from websites of a cross-section of Islamic financial institutions and presented without any element of tinkering.

Organization and Contents

The text is organized as follows. **Part One** spans over two chapters. Chapter One provides an overview of the Islamic financial system. It presents an interesting blueprint of the Islamic financial system with all its components. Prior to this, norms of ethics and efficiency and how these shape the contours of a financial system are presented. Chapter Two elaborates on the norms of Islamic finance, such as, prohibition of *riba* and *gharar* and the need for mutual cooperation.

Part Two spans over seven chapters dealing with products and services that broadly fall under commercial banking. Chapter Three sets the tone with a discussion of how conventional commercial banking is practiced and undertakes an assessment of the same from the standpoint of *Shariah* compliance. The Islamic alternative models of commercial banking, as these have evolved over time are then presented. Chapters Four-Nine undertake a more elaborate discussion of specific products and services. Chapter Four focuses on the liability side of the balance sheet of an Islamic bank and discusses various deposit-related products that help mobilize funds from the savings-surplus units. The spotlight then shifts to the asset side of an Islamic bank. Financing products of an Islamic bank could be equity or partnership-based or debt-based. Chapter Five is devoted to the equity-based financing products. Chapters Six-Eight discuss debt-based financing products. The more popular financing products based on *murabaha*, *bai-bithaman-ajil* and *ijara* are discussed in Chapter Six. Lesser popular financing products based on *salam*, *istisna*, *qard*, *istijrar* are discussed next in Chapter Seven. All controversial products are relegated to Chapter Eight. It includes all debt-based financing products that are widely perceived to be *Shariah*-compliant in form only and not in spirit. Chapter Nine discusses fee-based commercial banking products.

Part Three is devoted to insurance and comprises two chapters. Chapter Ten begins with how conventional insurance is practiced and undertakes an assessment of the same from the standpoint of *Shariah* compliance. The Islamic alternative models of insurance are then presented briefly. The Islamic insurance products based on *tabarru*, *mudaraba* and *wakala* are discussed in a more elaborate manner in Chapter Eleven.

Part Four comprises three chapters dealing with investment banking and financial engineering. Chapter Twelve initiates the discussion with how conventional investment banking is practiced and undertakes an assessment of the same from the standpoint of *Shariah* compliance. The Islamic alternative investment banking products – both in the pre-market stage and after-market stage are then presented briefly. Chapter Thirteen focuses on venture financing, creation of securities and other services, such as, stock broking. Chapter Fourteen is entirely devoted to risk management products based on derivatives and financial engineering. The Chapter undertakes an elaborate discussion of basic risk management products based on options, forwards and futures and swaps. Some innovative examples of Islamic financial engineering are presented as product possibilities.

Part Five is devoted to fund management and project finance and comprises three chapters. Chapter Fifteen discusses how funds are managed conventionally through various mutual funds, unit trusts and real estate investment companies. The Chapter undertakes an assessment of the same from the standpoint of *Shariah* compliance. The Islamic alternative fund management products are then briefly presented. Chapter Sixteen elaborates on various issues relating to the fund management products. Chapter Seventeen deals with project finance. It begins with a discussion of project finance as is undertaken in the conventional way and goes on to examine the issue of *Shariah* compliance. Some project finance structures that are deemed Islamic are then presented. The important issue of risk sharing and management in the context of project finance is then discussed.

The text is targeted at graduate students and practitioners who would like to be initiated into the new discipline of Islamic finance. It therefore, avoids use of mathematical proofs and derivations. It also avoids highlighting areas of disagreement among scholars on the Islamicity or otherwise of specific products, processes and mechanisms, as this would be highly confusing to a new entrant into the field. We have in the recent past witnessed sharp differences of views on many *exciting* products that seek to address an economic need but are deemed controversial and score low in terms of *Shariah* compliance. Current literature on Islamic finance is replete with publications

that try to make a case in favor or against a particular product, service or process. The text of course, makes no attempt to evade the all-important issue of *Shariah* compliance. In most cases, the consensus view of mainstream contemporary scholars is presented and all “controversial” issues are presented as they are – labeled as “controversial” and relegated wherever possible to a separate chapter.

For easy reading and comprehension, there are no footnotes, and no endnotes. **References** are neatly divided into five parts that correspond to the structure of the contents and are presented at the end of the book. Since the book steers clear of arguments and proofs, the references are more in the nature of **Suggested Further Readings** in the areas. Readers may note that wherever I have quoted from the holy *Quran*, the first numeral within bracket refers to *Surah* number and the second numeral after colon refers to Ayah number.

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