Islamic Finance: Short in Gambling, Long in Trade

Michael Saleh Gassner has a closer look at the basic principles of Islamic finance as an attractive alternative approach to Finance and Economics.

Islamic finance is a growing market: According to Saleh Kamel, Chairman of the General Council of Islamic Banks and Financial Institutions (GCIBFI), the total worldwide assets managed according to Islamic financial principles have reached USD 260 billion; there are 267 Islamic financial institutions; and the last 5 years' average growth rate was 23.5%. Almost every month, new banks enter the market, either as fully licensed Islamic banks or as special branches (Islamic window) of conventional institutions.

With the end of colonisation, Islamic banking was again on the agenda of Muslims. The emerging oil wealth of the 1970s gave the development a strong impetus. This newly reestablished Islamic banking is based on the respect of several principles derived from the teachings of Islam. Main focus is on how to conduct contracts (Fiqh Muamalat) based on broader moral objectives (Maqasid Shariah), namely, to achieve general well-being and good while avoiding evil, injury or loss for mankind. Wealth is morally acceptable; it should be spent in socially and ethically responsible ways. The poor are entitled to support, financed through a mandatory social tax (Zakat), which works as an incentive to keep cash invested instead of hoarded.

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The most prominent principle is the prohibition of interest on money lending (Riba)[1]. A similarly important term is 'Gharar', excessive uncertainty, which invalidates all deals to buy or sell if the object dealt with is not fully certain and transparent. For instance, the sale of an unborn camel is not valid, because it may not be born alive and its features and conditions are uncertain until birth.

Money lending and insurance

Based on these two eminent rules, Islamic finance can be divided in two sections:

The non-profit sector comprises money lending and insurances. Both areas may be based on a cooperative model for banking or insurance (Takaful). In Europe, two banks in Sweden (without religious foundation) are working fully interest-free: the JAK Medlembank and Nordspar. Their members (clients) are first saving interest-free for a certain period in order to receive an interest-free credit from the community bank. In some jurisdictions, interest-free credit is more tax efficient for high-income classes. In Germany for instance, a house buyer has to pay taxes for the interest received in the savings period but he cannot deduct the interest paid for a mortgage if he uses the house himself. An interest-free solution would therefore be preferable for tax reasons.

Equity markets and asset-based lending

Second, Islamic finance has a profit-oriented sector. This comprises the public and private equity markets as well as asset-based lending and other services. The profit/loss sharing financing (Musharaka, Mudaraba) is recognised as an ideal and universal mode of Islamic finance. In general, the emphasis on equity-based financing in the literature is prevalent. Equity financing could handle all financial needs like rents, wages, rates and assets, while the special financing techniques are oriented towards asset-based services. Islamic leasing (Ijara) is truly asset-backed, and mark-up financing (Murabaha) is debt originated through sales of assets.

There is some difficulty in understanding the distinction between a conventional money loan and an asset-based special financing in Islamic finance. The structure of Murabaha and Ijara is closest to conventional loans as their financing costs could be found benchmarked to the LIBOR rate. The benchmarking may, however, not be the optimum for the seller as he has to take into account the demand curve for the asset financed. He may sell more and increase total profit if he agrees on a discount for deferred payment buyers.

From a legal point of view, these special modes consist of a single sales contract (Murabaha) or rental contract (Ijara) with financing function, instead of a conventional money loan and buying contract. Ownership of the assets is crucial and prerequisite to legally finance them. This bears a much higher responsibility for fraud issues related to the financed item.

Another major difference keeps up: If a customer delays in payment there is no interest on late payment (Riba). Thus, compound interest is stopped short. Islamic banks deal with this issue by agreeing to a delay-fee paid to charity. If the reason for delay is due to personal pressure, no additional charges apply. The client, however, has no interest to delay without a good reason because he would have to pay this extra charge into a charity fund. Furthermore, he is ethically demanded under Islamic law to pay if he can and would have to justify noncompliance on the day of judgement.

Further there is no way of financing rates, wages or rents without equity. Hence the cornerstone of the capital structure

1 Quran, Sura 2, Verse 275, explicitly permitting trade, prohibits strictly Riba.

> *"Islamic finance leads to a strong relationship between real economy and financial markets."*

has to be equity. There is no compound interest mounting up, as debt is limited to the value of the initial assets, and hence vicious circles or debt traps as sometimes found in the conventional sector are precluded.

Derivatives

Another specific treatment is given for derivatives. Islam discourages gambling (Qimar) as well as excessive uncertainty (Gharar). Together, these rules were interpreted as incompatible with most modern derivatives. Nevertheless risk management is crucial to all advanced societies and the question came up how Islam recommends handling it. As trading is positive in Islam, and Muslims are recommended to be self-responsible and ethically bound by the rules of Islam, alternative transactions to manage risks do exist.

One of those is a down-payment (Arbun) to receive the goods with deferment. Its structure and economic outcome is close to an American option. It is agreed upon to receive the underlying asset during the stipulated time with the difference that the down-payment is deducted from the full price and in case of stocks the dividend has to be priced into the down-payment. This deal type is accepted by one of the four Islamic schools of law, the Hanbali (predominant in Saudi Arabia). The scholars of the other schools take a more critical stance towards this approach, based on one of the sayings of the prophet dismissing down-payment (Arbun). The Hanbali School, however, considers this not reliably transmitted.[2]

A further hedging instrument is the Salam Sale (prepaid sale), which is a sales transaction for immediate payment with future delivery. In history, this contract type was applied to agriculture. The seller is exposed to the full upward development in the price as long as he does not already own the goods. In Islamic law, the basic rule teaches that one is not permitted to sell what one does not own. This contract type, however, is considered as an exception and enables contracts for goods that are likely to be ready for delivery in future.

Unlike the flexibility in Western contemporary law, Islam sets strict rules for deals consisting of one deferred part – either payment or delivery –, and it is not permitted to defer both. Also the trade of the contract of Arbun (down-payment) and Salam Sale (prepaid sale)[3] is not seen to be permissible in order to avoid Qimar (gambling).

Hedge funds

In autumn 2003, the Saudi Economic and Development Company (SEDCO, www.sedcogroup.com) established the first hedge fund stated to be compliant with Islamic law, based on the above-mentioned prepaid sale and down-payment contracts instead of standard conventional options and short sales. Shariah Funds Inc. (www.shariahfunds.com), a U.S. offshoot of Meyer Capital, works on a fund of funds concept to create the next compliant hedge fund to target the institutional investors in the Middle East.

Beside differences in the methodology of hedging risks the underlying assets are of prime importance. In case of stocks they need to be screened for the Islamic finance criteria such as limited debt levels (30%) and exclusion of industry sectors like alcohol, pork, gambling and the conventional financial sector. Dealing in commodities is workable while doing so in currencies and stock indices is not.

The application of Islamic finance finally leads to a strong relationship between real economy and financial markets. Risk management is accepted while excessive speculation with risk management tools is prohibited. The debate on derivatives is going on. The purpose of risk management is recognised as valid with regard to the overall objectives, the unanswered question is, whether derivatives serve this purpose without involving impermissible gambling (Qimar) and excessive uncertainty (Gharar). According to the teachings of Islam,[4] these two evils would outweigh the potential benefits of derivatives.

To create standards a joint initiative of the International Swaps and Derivatives Association (ISDA, www.isda.org) with the International Islamic Financial Market (IIFM, www.iifm.net) has been recently started with involvement of the Middle Eastern regulators. The results will have to comply with principles and objectives of Islam as well as demonstrate a proper understanding of the empirical reality to be accepted in the Muslim world.

2 Obaidullah, M., "Islamic Risk Management: Towards Greater Ethics and Efficiency", International Journal of Islamic Financial Services, Volume 3, Number 4.
3 Bacha, O. I., "Derivative Instruments and Islamic Finance: Some Thoughts For a Reconsideration", International Journal of Islamic Financial Services, Volume 1, Number 1.
4 Quran, Sura 2, Verse 219, regarding gambling and wine, states that both contain some benefits, which, however, are outweighed by their evil.

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