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# Glossary Of Islamic Finance Terms

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## The Five Pillars Of Islamic Finance

### **The ban on interest**

Interest must not be charged or paid on any financial transaction, as interest (or the intrinsic value of the money) is deemed unlawful by Sharia.

### **The ban on uncertainty or speculation**

Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.

### **The ban on financing certain economic sectors**

Financing of industries deemed unlawful by Sharia--such as weapons, pork, and gambling--is forbidden.

### **The profit- and loss-sharing principle**

Parties to a financial transaction must share in the risks and rewards attached to it.

### **The asset-backing principle**

Each financial transaction must refer to a tangible, identifiable underlying asset.

## Vocabulary Of Islamic Finance

### **Bay salam**

A sales contract where the price is paid in advance and the goods are delivered in the future, provided that the characteristics of the goods are fully defined and the date of delivery is fixed.

### **Diminishing musharaka**

A form of partnership in which one of the partners undertakes to buy the equity share of the other partner gradually until ownership is completely transferred to the buying partner.

### **Gharar**

An exchange transaction in which one or both parties remain ignorant of an essential element of the transaction.

### **Halal**

Lawful; permitted by Sharia.

### **Haram**

Unlawful; prohibited by Sharia.

### **IFI**

Islamic financial institution.

### **Ijara**

Lease financing. The purchase of the leased asset at the end of the rental period is optional.

### **Ijara muntahia bittamleek**

A form of lease contract that offers the lessee the option to own the asset at the end of the lease period, either by purchase of the asset through a token consideration or payment of the market value, or by means of a gift contract.

### **Ijara wa iqtina**

Lease purchasing, where the lessee is committed to buying the leased equipment at the end of or during the rental period.

### **Investment risk reserve**

The amount appropriated by an IFI from the income of PSIA holders, after allocating the mudarib's share of the profit or mudarib fee (mudarib refers to the IFI as a manager of the PSIA), in order to create a cushion against future investment losses for account holders.

### **Istisna**

A contract that refers to an agreement to sell to a customer a nonexistent asset, which is to be manufactured or built according to the buyer's specifications and is to be delivered on a specified date at a predetermined selling price.

### **Mudaraba**

A contract between a capital provider and a mudarib (skilled entrepreneur or managing partner) whereby the IFI provides capital to an enterprise or activity to be managed by the mudarib. Profits generated by that enterprise or activity are shared in accordance with the terms of the mudaraba agreement while losses are borne solely by the capital provider, unless the losses are due to the mudarib's misconduct, negligence, or breach of contractual terms.

### **Murabaha**

The financing of a sale at a determined markup (cost plus profit margin).

### **Musharaka**

A contract between an IFI and a customer to provide capital to an enterprise, or for ownership of real estate or a moveable asset, either on a temporary or permanent basis. Profits generated by the enterprise or real estate/asset are shared in accordance with the terms of the musharaka agreement, while losses are shared in proportion to each partner's share of capital.

### **Profit equalization reserve**

The amount appropriated by an IFI from mudaraba income before allocating the mudarib share (fee; mudarib refers to the IFI as a manager of the PSIA), in order to maintain a certain level of return on investment for PSIA holders.

### **PSIA (profit-sharing investment account)**

A financial instrument relatively similar to time deposits of conventional banks. According to the terms and conditions of PSIAs, depositors are entitled to receive a share of a bank's profits, but also obliged to bear potential losses pertaining to their investment in the bank. PSIAs can be restricted (whereby the depositor authorizes an IFI to invest his funds based on a mudaraba or wakala, with certain restrictions as to where, how, and for what purpose these funds are to be invested); or unrestricted (whereby the depositor authorizes the IFI to invest his funds based on mudaraba or wakala contracts without laying down any restrictions).

### **Qard hasan**

A loan granted for welfare purposes or to bridge short-term funding requirements; it could also take the form of a nonremunerated deposit account. The borrower is required to repay only the principal.

**Retakaful**

A form of Islamic reinsurance that operates on the takaful model.

**Riba**

Usury.

**Sharia (or Shari'ah)**

Islamic law.

**Stability rating**

A rating that represents Standard & Poor's current opinion about the prospective relative stability of cash flow distributable to PSIA holders.

**Sukuk**

Sharia-compliant financial certificates similar to bonds.

**Takaful**

A form of Islamic mutual insurance based on the principle of mutual assistance.

**Wadia**

An amount deposited whereby the depositor is guaranteed his funds in full on demand.

**Wakala**

An agency contract where the investment account holder (principal) appoints an IFI (agent) to carry out an investment on his behalf either for or without a fee.

Sources: Islamic Financial Services Board and Standard & Poor's.

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