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.EDGY GLOBAL.

**Global Islamic Finance and Banking Course**

**(Summarized notes)**

Global Education Partnerships

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# **Summary:**

The Global Islamic Finance and Banking course published by Edgy Global covers the key concepts, services, and future of this growing sector.

The size of the Islamic banking and finance sector is more than $2 trillion globally and it represents one of the fastest growing financial sectors.

This course will benefit anyone who is interested in Islamic finance and banking around the world.

You may be a current or future Islamic Finance customer either Muslim or Non-Muslim.

Or maybe you work in banking services that sees the current growth and future global potential Islamic Finance and Banking represents.

Or you could be an elected government official or working for the government and interested in the regulatory framework and benefits of supporting Islamic Finance development in your country.

Whatever your background participants will gain knowledge and an understanding of Islamic finance and banking which encourages mutual cooperation, generosity and risk sharing for the benefit of the community.

# **Publisher:**

Edward Fraser MBA GAICD BAS TI ICMA FCHSM

Developing a range of global courses including governance, anti-corruption, and health management.

Edgy Global. Email: partner@edgyglobal.com

# **Expert Lecturer:**

Almir Colan, Founder and Director, Australian Centre for Islamic Finance (AUSCIF) and CEO at Olive Investments. Almir is also an adviser to number of institutions that provide Islamic finance and member of a working group at AAOIFI.

Previous, Almir was a consultant lecturer and advisory board member for the Master of Islamic Banking and Finance Course at La Trobe University; Member of the Advisory Reference Group for the Bachelor of Accounting/Associate Degree of Accounting at NMIT; and Executive Board Member at Islamic Council of Victoria (ICV);

**Course Description:**  
The Global Islamic Finance and Banking course provides an introduction to Islamic banking and finance and focuses on the benefits, key principles, services, modes of financing, and future opportunities.  
  
**Learning Objectives:**

1. To understand Islamic finance in contemporary society.

2. To understand the benefits of Islamic finance and banking.  
3. To understand the main principles of Islamic banking and finance.  
4. To understand how different Islamic modes of financing work.  
5. To understand the current market and future opportunities for the sector.

**Module Learning Outcomes & Summaries:**

Module 1. Introduction - Learning Outcomes

It is planed students will be able to:

1. Define Islamic Finance.
2. Define Shariah.
3. Understand the Islamic perspective of wealth.
4. Understand Islamic finance growth and future potential.

Module 1. Summary

At the end of Module 1 students will be able to:

* Define Islamic finance.
* Define Shariah.
* Define Islamic finance is set of rules that are Shariah compliant.
* Highlighting the Islamic perspective of wealth.
* Understand the history of modern Islamic finance and.

Module 2. Islamic Law & Contracts - Learning Outcomes

It is planned students will be able to:

1. Explain Sources of Islamic Law (Shariah)
2. Learn the actions of Islam.
3. Learn common elements of a contract.
4. Learn of different ownership categories.
5. Learn the classification of contracts.
6. Learn key contract conditions.

Module 2. Summary

At the end of Module 2 students will be able to:

* Understand the key sources of Islamic Law is the Qur’an and the Sunnah.
* Define actions of Islam.
* Highlight common elements of a contract.
* Understand ownership categories.
* Understand the classification of contracts.
* Understand key contract conditions.

Module 3. Modes of Finance - Learning Outcomes

It is planned students will be able to:

1. Understand prohibition of Interest (Riba)
2. Understand prohibition of uncertainty/risk (Gharar).
3. Understand how Islamic insurance (Takaful) works.
4. Understand debt and equity based finance.
5. Understand different modes of finance.
6. Understand the difference between Islamic and conventional banks.
7. Understand key consideration when choosing an Islamic product.
8. Understand how Islamic housing finance works.

Module 3. Summary

At the end of Module 3 students will be able to:

* Explain the prohibition of interest and uncertainty/risk.
* Explain how Islamic insurance (takaful) works.
* Explain difference between Debt and Equity based financing.
* Explain the difference between Islamic and Conventional banks.
* Explain the different modes of finance.
* Explain key consideration when choosing an Islamic product.
* Explain how Islamic housing finance works.

Module 4. Regulatory Issues - Learning Outcomes

It is planned students will be able to:

1. Understand the role of independent Shariah boards?
2. Understand legal and regulatory environment.
3. Understand Islamic finance potential.

Module 4. Summary

At the end of Module 4 students will be able to:

* Define the role of independent Shariah boards.
* Highlighting the link between Shariah, law and business opportunities.
* Contact the publisher to provide feedback on the course or ideas on how it can be promoted globally.

# **Module 1. Introduction to Global Islamic Finance and Banking**

Topic 1.1 Introduction

**Edward Fraser**, Global Publishing

MBA GAICD BAS FCHSM

[Partner@edgyglobal.com](mailto:Partner@edgyglobal.com)

Welcome to the global Islamic finance and banking course.

We are pleased to be introducing this course.

The Islamic Finance sector represents almost a quarter of the world's population and is already worth over two trillion dollars globally which makes it one of the fastest growing finance sectors in the world.

This course has been designed for both Muslims and non-Muslim and is relevant to all finance and banking professionals, and also regulators, politicians and law makers that are open to improving their country by understanding what can be done in the Islamic finance space for the mutual benefit of their community, citizens and businesses.

We are pleased to be working with Alison.com that is one of the world's largest education providers with over 11 million students and a worldwide accessible platform for all, regardless of income.

We are very lucky and pleased to be working with Mr Almir Colan who is an international Islamic finance expert. He has advised individuals and institutions around the world. He is also currently on the working group of AAOIFI.

Previously, Almir was the consultant lecturer and advisor in the masters of Islamic finance and banking course at Latrobe University as well as holding numerous other roles on boards and as an advisor in Islamic finance.

It is as a result of Almir’s work that we are able to put together this course in global Islamic finance and banking. Please take your time and enjoy the course.

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| FEEDBACK:  We welcome feedback, speaker requests, joint marketing ideas to ensure  this course is available to all globally. Email: [partner@edgyglobal.com](mailto:partner@edgyglobal.com) |

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**Almir Colan**.

Assalamu alaykum. My name is Almir Colan and I will be your instructor for this Islamic finance and banking course.

I have been teaching Islamic finance and commercial transactions for over 10 years.

As a consultant lecturer I taught Master students in the area of Islamic finance and Islamic capital markets where I also served as advisory board member for a University Master of Islamic Banking and Finance Course.

My wish is that in this course you realize and learn the Islamic take on money, finance and business transactions and understand the importance of aiming high in your life not only for yourself but for your community.

Topic 1.2 What is Islamic Finance?

Islamic finance represents financial activity that is consistent with the principles of Shariah.

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| **Islamic finance represents financial activity that is consistent with the principles of Shariah.** |

Shariah law prohibits unethical, immoral, speculative activities as well as interest, gambling, and uncertainty.

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| **Shariah law prohibits unethical, immoral, speculative activities as well as interest, gambling, and uncertainty.** |

Islamic finance encourages entrepreneurship, mutual cooperation, generosity, and spirit of partnership which connect the capital owner with the real economic activities that may actually contribute to the welfare of society via commerce, manufacturing, construction and related areas.

This of course is not only limited to modes of financing but also covers all business and financial transactions and rulings.

All of us are required to seek lawful wealth for our needs, attain self-sufficiency, and provide shelter and so on.

There is a high demand from the Muslim community for Shariah compliant alternatives to conventional finance.

Much concern revolves around what is allowed and what is not in Islamic Finance.

Shariah lays down rules that promote fair dealing and business ethics based on universal principles. These universal principles also consider the community needs that contribute to a healthy society.

Topic 1.3 What is Shariah?

Shariah is a “set of rules” that define certain prohibitions, obligations, recommendations and so on.

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| **Shariah is a set of rules that define certain prohibitions, obligations, recommendations and so on.** |

So, when scholars looked at the Shariah and what its aims are, they discovered that the core aims or objectives (maqasid) can be summarized into five areas as follows.

The five areas that Shariah is trying to preserve are:

1. Religion,
2. Life,
3. Progeny and family,
4. Intellect & honor; and,
5. Wealth.

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| **Core five aims and objectives of that Shariah are preservation of:**   1. **Religion,** 2. **Life,** 3. **Progeny and family,** 4. **Intellect & honor; and,** 5. **Wealth.** |

When you look at these rules of the Shariah you will find that various prohibitions and obligations work in some way to protect all of these areas of life.

When we don't engage in interest and other speculative business dealings, we are protecting our wealth and our economic system.

So, Shariah lays down certain rules and principles to do this.

Therefore, the rules of the Shariah uphold these while at the same time, lay down measures to defend them from any harm.

Topic 1.4 Islamic Perspective on Wealth

Wealth can be defined as anything that is legal, permissible in Shariah, usable and useful, it has some material or economic value, is capable of being bought, sold or stocked, has legitimate use and can be a physical item, or intellectual property.

Topic 1.5 Growth and Potential of Islamic Finance

Islamic banking is growing and it is estimated that this growth represents one of the fastest growing financial services in the world.

Some have estimated the growth at ten percent or even more per annum and today the sector of Islamic finances is valued between two to three trillion dollars USD.

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| **Islamic Finance sector is worth between $2 trillion to $3 trillion USD.** |

In addition the size of the global Muslim population is expected to increase to 2.2 billion people by 2030 or 26% of the world's population.

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| **Population Size = 2.2 Billion Muslims or 26% of world**  **population by 2030.** |

Muslims are becoming more and more aware of the importance of following life according to Shariah and especially in terms of their approach to finance, business and other dealings.

We see from the research that more and more people want to have an Islamic bank account, finance their home, or invest money in Islamic way.

Topic 1.6 Historical Context of Modern Islamic Finance & Banking

When we look at the historical context of Islamic Finance and Banking it is interesting, to know that Islamic finance principles have been with us for centuries, but as an institutionalized approach we have only seen development of this industry in the last forty to fifty years.

It was only in the 1960s and 1970s when early banks or institutions started in Egypt, Pakistan, Malaysia and other places around the world.

So, in the 1960s we have seen the development of some profit sharing institutions that were not necessarily commercially viable as a business, but they gave rise to the idea and inspiration to what has later become the Islamic finance industry.

It was in 1970s when some of these Islamic Banks, like Dubai Islamic Bank and Islamic Development Bank started commercial operation, were established and we can see the growth of Islamic finance.

With growth, number of institution started similar operations and we have seen even mainstream discussion about Islamic finance banking such as major world indexes like Dow Jones star in 1999 launching Islamic market index.

We have today magazines that track performance of these Islamic institutions.

With thousands of institutions, for example, one of the magazine ranks five hundred top Islamic finance institutions in the world and just a couple years ago, we have seen a consortium of Islamic banks launch its own alternative to LIBOR, which is an international Islamic interbank rate.

# **Module 2. Islamic Law & Contracts**

Topic 2.1 Sources of Islamic Law (Shariah)

Primary sources of Islamic law are the Qur’an and the Sunnah.

The Qur’an was revealed to the Prophet Muhammed (PBUH) in Arabic language. The Qur’an is the Word of God and the final revealed book to the mankind.

Muhammed (PBUH) would receive the verses of the Qur’an via the angel Gabriel (Jibreel).

The Prophet (PBUH) would relate the verses he heard from the Angel and his scribes would record them.

Over fifty scribes contributed to the recordings of the Qur’an during the Prophet’s (PBUH) lifetime.

The Qur’an remains unchanged as it was revealed fourteen centuries ago.

Although, the Qur’an covers details of beliefs, ethics, lessons from history, guidance, it also includes laws that relate to family, criminal law, state law, and trade business laws.

The basic methodology to interpret the Qur’an relies on the following;

1. Understanding the Qur’an from other passages in the Qur’an;
2. Understanding the Qur’an by way of the Sunnah, (will cover next), or the teachings of the Prophet;
3. Understanding the Qur’an by the way of the companions of the Prophet, and;
4. Delving into the linguistic meanings of the Arabic words.

The Sunnah refers to the teachings or known practices of the Prophet Muhammad (PBUH), which have been recorded in the volumes of Hadith literature. These resources include many things that he said, did or allowed.

During his lifetime, the Prophet's (PBUH) family and companions directly learned from him and observed him and related to others what they had seen and heard.

People also asked the prophet directly for rulings on various matters and He (PBUH) would pronounce his judgment.

Although, the Sunnah complements the Qur’an and is used to further understand the Qur’an, it is also used as a source for many other rulings not explicitly mentioned in the Qur’an.

There are over forty verses in Qur’an that command believers to obey the messenger and follow his Sunnah (PBUH).

Many scholars over the years gathered and compiled large compilations and we know some of them such as Muwatta of Imam Malik and Musnad of Imam Ahmed.

**Secondary sources of Islamic law.**

**Ijmah or consensus.** Many rulings do not require further interpretation. Ijmah (consensus) refers to the rulings that have been agreed upon and are established as truth. Such rulings are not eligible for re-interpretation.Therefore, it is upon the scholars to know what has been established as law according to consensus.

**Ijtihad or juristic opinion.** When the clear ruling cannot be directly found in the Qur’an and in the Sunnah, the Muslim jurist or Mujtahid may practice Ijtihad or juristic opinion.

The main purpose of Ijtihad is to strive and deduct the correct ruling and comprehend the intent of the law maker.

A common feature of Ijtihad is interpretation based on Qiyas or analogy.

Ijtihad continues to answer many issues as they emerge. Specifically, we will see this in the world of Islamic finance where many of these contemporary arrangements are subject to Ijtihad and we will discuss some of them in this course.

Scholars also take into consideration the aims and overall objectives of the Shariah.

Topic 2.2 Actions in Islam

Scholars have divided actions in Islam in two broad categories. These two categories are known as Ibadat and Muamalat.

Ibadat or what is commonly translated as acts of worship. These are the things and action that refers to anything that is done sincerely and solely to Allah, such as our prayer, fasting and Hajj (pilgrimage).

Such acts of worship rely on proof within the sources of Islam, for their endorsement and conduct. We are looking for evidence in order to establish that act of worship and whenever we bring a practice or opinion when it comes to these acts, we look for the evidence.

So, this is very well-known principle in jurisprudence (usul al-fiqh) that when it comes to Ibadat, all acts of worship are prohibited unless there is a proof in the text that they are allowed. Ibadat is very prescriptive.

Muamalat refers to any type of interaction between people. This includes such things as trade partnership laws and Islamic finance.

Unlike Ibadat, a general principle that applies to Muamalat is that everything is allowed except for what has been prohibited.

The Prophet (PBUH) said what is lawful is clear and what is unlawful is clear and between them are doubtful matters which many people do not know. [Related by al-Bukhari and Muslim]

Topic 2.3 Contract & Business Transactions

A contract is a legally binding agreement. It creates a legal relationship with regards to the subject matter.

If you agree to buy or sell something and one party does not want to honor that agreement, you can take that person to a judge for a ruling because a contract is a legally binding agreement between two or more parties.

Topic 2.4 Common Elements of a Contract

It is very important to understand when it comes to contracting parties, they must be people who can enter into these contracts.

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| One contract condition is that people be of sound mind, and have the authority to represent the business or goods being sold. |

Second part of the contract is offer and acceptance.

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| A second part of the contract is offer and acceptance. |

Another important piece of a contract is unity of Majlis, of the meeting, which is one of the conditions of the contract for it to be valid.

Contract is something that takes place in a meeting and if we want the contract to be fully compliant and binding, then that arrangement must be done in that particular meeting and that is why the Prophet (PBUH) said that the contracting parties have the right of “option” to finalize or not until they separate.

In practice it means to avoid any uncertainty in terms of what's concluded, you should actually indicate whether the contract is binding and finalized in that meeting where you are organizing the business, and even if you have concluded the arrangement, you have a right to rescind the sale before you separate.

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| Another contract condition is that there is a meeting (majlis) of parties to  agree to the contract. |

In general, if you are not sure about your arrangement and what you are doing, sometimes as the Prophet (PBUH) advised it's good to have a three-day option where you can still cancel that contract.

It's similar to those cooling off periods that you sometimes find in western contracts.

Subject matter is the item that is being sold or bought, something that we are transacting in this financial or commercial arrangement.

So, before we can sell something in this contract, we must understand that Shariah puts certain conditions like that these things should exist, should have value from Shariah point of view as well as economically. 

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| Another contract condition is that must be something that exists and  has value to be exchanged as part of a contract. |

There should be some usefulness to this subject matter, it should be usable, capable of ownership, you should be able to deliver it, specify, quantify and so on.

If a non-existent thing is sold, even in mutual consent, the sale is void according to the Shariah. (This refers to things where there is high uncertainty of delivery)

Topic 2.5 Types of Transactions

When you look at any transaction we exchange ownership of thing(s) that we are buying and selling and there is consideration or payment.

When you look at the transactions for exchange of things, we can classify them in three very broad categories. (Sale, Loan and Lease)

SALE: Can be a cash sale or a credit sale.

What that means is when you are selling the item, you're transferring the ownership to someone else for some money and that money could be paid immediately.

This is what we call sale on the spot if the money is paid immediately.

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| Cash on the spot sale is when transfer of ownership occurs for money that is paid immediately. |

Or you could say give me that money in installments. This is what we call credit sale or deferred payment basis.

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| Credit or deferred payment sale is when transfer of ownership  occurs for money that is paid in installments over an agreed period of time. |

LOAN: A loan is another type of transactions (usually used by benevolent institutions in Islam and have its own rules such as prohibition of earning interest on any loan).

LEASING: This is another type of transaction and all of these three transactions will have different implications in terms of transfer of ownership or risk in liability.

Loan is type of a transaction which is free of any charge. It is a temporary transfer of ownership of goods, asset, and it is free of any payment. It is designed to help someone temporarily.

Islam wants to differentiate between commercial transaction when we enter in the profit-making arrangement (like sale and lease) and a transaction which is charitable, which is a loan, where you are not allowed to make a profit.

In terms of the leasing, only the usufruct or the right to benefit from the asset is made available to the lessee (in return for rent or lease payments) but not the ownership of the asset.

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| In terms of the leasing, only the usufruct or the right to benefit from the  asset is made available to the lessee (in return for rent or lease payments)  but not the ownership of the asset. |

In a lease we are transferring usufruct (the right to use specific asset temporarily) to the person for the payment of rent.

In this case that ownership stays with the original owner.

So, ownership remains with a lessor, but he's entitled to rental payments and is also liable for expenses relating to ownership and loss of asset if any.

Topic 2.6 Ownership Categories

There are three different categories of ownership.

Firstly, you can own the asset.

Secondly you could be the owner of a debt.

Thirdly you can own the usufruct, the right to benefit from the good.

Topic 2.7 Classification of Contracts

For a contract to be valid all elements of the contract must be in order and valid.

Conditions in a contract must be honored as long as they do not breach the Shariah.

Topic 2.8 Contract Conditions

This topic will cover conditions within the contract. An example of a permissible condition with a loaned item is the owner may require a security deposit until the item is returned or a photocopy of the borrower’s identification. Another example of a contract condition is a lease with these options; the lessor of the car may have conditions for the lessee not to drive it off road. Also, the lessor of a house may stipulate “no pets are allowed” as a condition.

Some conditions can be unlawful. Unlawful conditions refer to what is prohibited by Shariah such as sale and lease in one contract or interest-bearing penalties for late payments. If the Shariah has stipulated a law that is binding, it may not be changed by a condition.



Even if people may mutually agree on conditions that are not aligned with the rules and intentions of Shariah, these conditions are invalid.

One example is combining two contracts into one and combining these contracts which are conditional upon each other.

When it comes to commercial and business transactions, we have certain elements in the contract and in order to make this arrangement legally binding, and in the spirit of Shariah, we need to understand all of these different rules.

You will find that Shariah has conditions and therefore in Islamic finance we have some rules where in order to benefit from money, in the commercial sense, we need to transfer money from monetary assets into real economic assets in order to make profit.

# **Module 3. Modes of Finance**

Topic 3.1 Prohibition of Interest (Riba):

One of the first traditional topics that we cover when we are talking about prohibitions is the prohibition of Riba.

When we are looking at a language and the literal meaning of Riba simply means increase.

Now when we look at the more Shariah definition of this increase, we see that refers to this particular increase that is unlawful. Or comes from a particular transaction where the increase is not desired.

In English translation we will usually find that Riba is translated as either Interest or Usury (excessive interest).

If we look at history we will see that in Christianity, interest was also prohibited. But then people who wanted to make this particular profit permissible divided the increase into two categories. One that is a small amount (and they called it interest) and the second one is an increase that is a lot, excessive (and they called it usury).

This is the way people used logic and reason to go around the prohibition of interest.

Now, in Islam, we do not make this distinction between a little bit of interest and a lot of interest. There is nothing called ethical interest, or a little bit of interest is fine. Any type of profit that results from these transactions (Riba transactions) is interest, that is prohibited, and it is haram (prohibited) regardless of amount.

Some wisdom behind prohibition of Riba (interest):

Riba (interest) goes against mutual cooperation, generosity and spirit of partnership.

Another wisdom behind prohibition of Riba is found in its possibility to facilitate injustice and exploitation and acquisition of the property by wrongful means, and to harm the needy.

Riba drives the capital-owner away from enterprise and real economic activities that contribute to the welfare of the society, through commerce, manufacturing, construction and so on.

Money in reality is meant to be medium of exchange and standards of value for other goods.

Therefore, Riba violates this rationale for which we have money, as it diverts it from real economic activities and what it is meant to do.

Topic 3.2 Prohibition of Excessive Risk (Gharar)

Another prohibition is Gharar which is excessive uncertainty or risk. (Note: Not all forms of Gharar or risk are prohibited. Standard risk/uncertainty that is present in typical business transactions and ventures is permissible).

Abu Hurairah stated that, “The Prophet PBUH forbade selling by way of tossing stones to settle a sale (Al-Hassah) and a sale of Gharar (Muslim).

Whenever we have a contract or an arrangement or a business transaction, that makes someone believe something that is false or vague or puts someone in a dangerous position due to deception by showing something that looks attractive, but in reality, is not, we are talking about prohibited transaction that falls under the prohibition of Gharar.

Some of the examples of these transactions include, ignorance for instance and the lack of transparency.

Selling what we do not have is a situation where a person might engage in a transaction, where there is a high level of uncertainty in terms of delivery of the product.

Having unspecified price, dates or delivery, quality or quantity of the product that is not clear is not fair or allowed.

We have seen during the global financial crisis that complex financial transactions were created that caused global issues that hurt many people across the world. CDOs (type of financial product) that were the collection of many loans with poor credit ratings were sold and rated as a safe investment product. Most people did not know what they are signing or what they were buying or even what they were rating, and we can see that especially in complex transactions, this violates a number of Islamic prohibitions such as Gharar.

When we talk about Gharar we have major Gharar and we have minor elements of Gharar.

Not all of them are the same.

So, there are some types of risks or uncertainty which we tolerate in business transactions but there are those major issues of uncertainty and deceptions that we cannot tolerate.

So, when we are screening for what is acceptable level of Gharar in any transaction, we look at things like:

1. Is this amount of uncertainty negligible?
2. Is it present in all transactions?
3. Is it inevitable?
4. Can it be avoided?
5. And is it unintentional?

Gambling is extreme form of Gharar, and we see this clearly prohibited in Qur’an, and it involves no skills.

Sometimes people are confused between the meaning of investment and gambling because they both carry certain risks and so on.

Investment is desirable activity and it includes all these different skills and so on, where the gambling is purely based on luck and not on any particular skill.

We have only mentioned some of the prohibitions in business transactions.

We don’t have time in this course to go through many of them, but we have covered some of the key and basic ones that relate to Islamic finance.

There are many other prohibitions and ethical principles that we should be aware of when we are dealing in the business transactions but these are outside the scope of this initial introductory course.

Topic 3.3 Islamic Insurance (Takaful)

If you look at the conventional insurance versus Takaful, (Islamic insurance), you can see conventional forms of insurance involves the elements of chance (Gharar), and often interest (Riba).

Takaful has therefore been designed as a Shariah compliant alternative, and this is the modern form of what we call ‘Islamic insurance’.

An ‘insurance’ system that was practiced during the time of the Prophet Mohammed PBUH (over fourteen centuries ago) forms the basis for the modern day Takaful concept.

So, in case of a calamity, individuals from a particular tribe sought to contribute from their own resources until adversity was relieved.

We see that Takaful comes from the Arabic word ‘Kafala’ which means to guarantee something, and Takaful therefore is a shared responsibility, shared guarantee or mutual undertakings (Kettle 2008).

Generally, participants pay a fee known as ‘tabarru’ (donation or contribution), and therefore, they are sharing the risk or responsibility. The difference from conventional insurance here is the case where the premiums paid to transfer the risk to a third party while in Takaful this risk is shared based on a basis of mutual help and joint responsibility.

Also, the money from contributors is placed in the pot or a pool of money that is utilized for investment, paying the Takaful operators and most importantly, to cover the losses of contributors if they make a claim.

Topic 3.4 Difference between Islamic and Conventional Banks

In a conventional bank money is considered a ‘commodity’.

Most of the conventional banking products are designed to sell you money like your credit card, bank loan, car loan and personal financing.

Subject matter of all of these contracts is actually money, and that for instance includes the home loan when the bank gives you money to buy a house.

In reality, they are giving you a loan contract and a transaction between two of you is money for money.

The house in this case is not the subject matter. It's simply collateral in that transaction. In case you are a faulty or something happens, there is the house to be sold.

In an Islamic bank, money must be used as a medium of exchange only.

So, before we make a profit, money must be converted to some sort of asset, something that is useful.

And we can sell this asset for the profit, and that is a legitimate business transaction.

So, linking money to productive purposes brings into action labor and other resources to initiate a purchase from which goods and services are produced and benefits passed on to the society.

We can see the difference between Islamic and conventional banks is really what they deal in.

Islamic bank deals in goods and documents, not in money.

Conventional banks deals in money and documents, not in goods.

So, in an Islamic bank money is only used as a medium of exchange for purchasing the goods for the purpose of leasing or selling and so on and in the conventional bank money is considered as a commodity that can be sold or bought or rented against the profit.

Topic 3.5 Modes of Islamic Financing

So, when you look at the modes of financing, there are two areas.

One mode of financing is based on partnership and the second mode of financing is debt based.

So, for example, a partnership mode of financing would involve a contractual arrangement with shared profit and loss.

We enter together, we share (profit) from the underlying performance of the business if it performs well, or we share in the loss if it doesn't go so well.

Now, in a debt-based financing mode of finance, we have arrangement where I simply sell something to you let's say, and you owe me some money or I lease something to you and I know what to expect in terms of the cash flow in the future.

So, based on these two arrangements, profit and loss or non-profit and loss mode, we have two different types of financing.

Now, when we talk about making money, we understand that you can only really make money by selling something or leasing or entering some sort of partnership arrangement.

We will look at the sale and lease separately in order to understand what the rules regarding the lease and the sale.

We will also look at different types of partnerships.

So, if you are financing, let's say, homes or a vehicle through partnership like Musharaka, the same lease and sale rules will apply.

* How will you take ownership of the asset?
* How is the asset priced?
* What are your responsibilities, liabilities, risk and so on?

So, as we said we have a number of different modes of financing such as Musharaka and Mudaraba and also Murabaha and Ijarah. But we also have other modes of financing, and there are number of different other ways that Islamic banks or the institutions might choose to make a profit from charging certain fees for the services or performance.

The following will cover 4 modes of finance.

1. Equity partnership / joint venture which is known as Musharaka.
2. Investment partnership (called Mudaraba) & Banking.
3. Leasing (called Ijarah) & Leasing vs Sale
4. Cost plus sale (Murabaha)

These are further detailed below.

a) Equity Partnership, Joint Venture (Musharaka)

Musharak is commonly translated as joint venture partnership or equity partnership.

The partners in this venture would share profit and loss from the business activities that they are undertaking.

It is called equity partnership and the mode of financing is equity-based mode of financing.

The idea of Musharaka is to join resources to generate profit.

One of the primary rules is that profit can be negotiated.

Before we start we must agree on what is going to be the profit ratio.

Different partners might choose to participate more or less in a business and so the profit ratio can be changed.

For example if one partner chooses to be more involved in the business, comes with experience or adds additional value to this partnership then (Partly due to this increased involvement in the business) he might get higher share of the profit and this is to give incentives for the partners to work harder.

If a party is a sleeping partner, then they cannot get from profit share than what was their capital contribution (ratio).

The profit ratio is something that must be agreed before we start the business.

When it comes to the loss ratio this is fixed according to the capital contribution. We cannot negotiate.

It is fair because if you could negotiate, usually the stronger party would negotiate in such a way, with the upper hand, to push more loss on to the weaker parties.

While at the profit side, the reason why we can negotiate is because of the potential for incentives.

So, for example, if we increase performance of the business or a profit everyone gains more.

So, it is better to have fifty percent of a business that makes, let’s say $5 million in profit, than ninety percent of business that makes just $1 million in profit.

So, this is something that is used to encourage innovation, competitiveness and performance.

We also have “Diminishing Musharaka” which is a form of partnership, in which one of the partners’ promises to buy the equity share of the other partner gradually until the full ownership is completely transferred to him.

b) Investment Partnership (Mudaraba) & Banking

Other type of partnership is what we call Mudaraba or investment partnership, and this is an arrangement where one party invests capital and the other party is like a manager and they provide the time, expertise and skills to manage the partnership.

This is different to Musharaka where both of the parties invest some resources that are identifiable, and clear because if we have a situation where we have a loss, we have to know what the original capital contribution was.

Banks deal with money but in general they mobilize the funds from people who have money surplus.

So, in this case, the bank is acting as a Mudarib, that collects investments. For example, let's say we want to make an investment account. The bank would act as a Mudarib, to collect the money and do something with the money.

In this case, people who open an investment account they would be those people who are like investors in Mudaraba.

So, when the bank collects money acting as a Mudarib and all of these account holders are investors, then the bank would do something with that money to make a profit.

So, in most cases this would be to provide financing.

For instance, through Musharaka, for people to buy the homes.

Any profit from that rent that is paid to the bank would be then split.

So, for instance, the bank might take 20% and all of the rest of the 80% would be distributed between the depositors who have investment accounts.

But the whole idea is that we mobilize the fund through Mudaraba for example and bank would use that money.

The money is really connecting with the economy and providing benefits in society.

So, we see that the Islamic idea of the bank or financial institution is to participate and transfer money from being a monetary asset into being an economic asset and benefiting the real economy in the process.

c) Leasing (Ijarah) & Leasing vs Sale

The legitimacy of Ijarah as very well established in the Qur’an. In the Sunnah also, we see reference to paying the workers before their sweat dries.

In general, in jurisprudence when we talk about a lease or Ijarah, it is talking about employing somebody on wages. To employ the services of a person on wages and lexically this means ‘to give something on a rent’.

There is another type of lease related to the use of a property which is transferred in exchange for a rent. This is similar to your normal lease that you engage in when you hire the car, or you lease the house.

So, when you look at that contract we have the subject matter that we are transacting is usufruct or a right to use that particular property, and your rent is consideration or a payment.

In a sale, the asset itself or the corpus of the property is transferred while in Ijarah, the ownership of the property remains with whoever is the owner, and what we transfer is only right to use to the lessee.

This will bring different sort of liabilities and different risks to the person who owns the property.

When you are leasing, as owner, you have certain rights and responsibility towards the property, and when you sell, you then transfer everything to the person who is buying because as you know the sale is instant transfer of ownership.

d) Cost Plus Sale (Murabahah)

Another mode of financing is debt-based financing called Murabahah. You sell something at a markup, at some fixed price and it is very similar to a normal sale.

All of the rules of the sale would apply to this particular transaction. Sale in Shariah is defined as ‘exchange of things of value by another thing of value with mutual consent.’

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| Sale is defined as exchange of things of value by another thing of value with  mutual consent. |

When you engage in a sale, you immediately transfer ownership for the payment, and even if that payment is not on the spot, effect of sale is immediate.

Some of the rules regarding the sale:

1. The subject matter in a sale must exist at the time of the sale. You cannot sell something in this particular arrangement where the deliveries are not certain or there are some issues with the existence of this asset.
2. The subject must be in the ownership of a seller at the time of the sale. You cannot sell a car which you do not own at the time of the sale. That would not be valid because again you cannot guarantee that you get the car and the specifics of the car might be in question later on.
3. The subject of the sale must be in your possession whether it's physically there or some sort of constructive possession.

You have taken the physical delivery of the commodity and it is coming to your control with all the rights and liabilities that comes with this. The best way we know this is whether the risk of destruction has also come to you.

As soon as you sell something, that transfer of ownership of the asset is instant and absolute.

The subject of the sale must be like any other contract of value and must satisfy all of the usual conditions.

It must be known, identifiable and very clearly identified.

We must be then also certain that we can deliver.

We cannot sell something where there is uncertainty in terms of the price.

But once we sell an asset, we cannot change the price.

So, in the sale, always the price is fixed.

Now, when we come to the Murabahah and sale on the deferred payment basis. The scholars agreed that deferred price may be more than a cash price but it must be fixed at the time of the sale.

So, we could have a price for the cash and we could have a price if person is paying in installments and there is no problem.

As long as we fix this from the beginning and everyone is clear on the price and agrees.

So, as long as we agree at the end on the one price, it has become a process of offer and acceptance, and we agree on one price and on the set of conditions, this is valid sale.

So, this is the job of Shariah scholars to make sure that everything is transparent and clear and it's genuine.

Topic 3.6 Choosing an Islamic Product

There are a number of things we need to look at when it comes to choosing which Islamic product to select, whether we are investing in a partnership or taking financing from an institution or considering other Islamic finance or banking services.

Some to consider are:

1. Is the Product Shariah compliant?
2. Who are the people on the Shariah board?
3. Is information on the products easy to understand.
4. How much trust do we have in the people who serve the organization we are dealing with?
5. Are the people involved positive advocates, and/or activists for Islamic finance?
6. Do we see them practicing what they preach?
7. Does the agency have the support of the community and willingness to improve and consult?
8. Is the pricing fair?

If you can find the time more detailed consideration are highlighted as follows:

1. Who or how is the organization funded?
2. How are relations with the customers managed?
3. What are the details of the contracts?
4. How is the ownership transferred?
5. What are the conditions in the contract?
6. Is the contract fair, and valid?
7. Is it just changing the words?
8. Why are these conditions there?

We make a judgment as best we can with the best information we have access to at the time.

Topic 3.7 Housing Finance

This topic covers home financing which is one of the largest assets most of the people will own in their life for their family and themselves.

# **Module 4. Regulatory Issues**

Topic 4.1 Role of Independent Shariah Boards

An independent Shariah board exists to provide genuine feedback and information that the community can trust.

The role is critical because they can guide institutions, and they can lead research and development.

It is also important that the board have understanding and look beyond their local countries and can see real economic substance, what is really happening and the opportunities for Islamic finance and banking which will serve the community.

Importantly the scholars involved should also have the opportunity to provide feedback independently that will guide the industry and serve the community.

The role of the Shariah board can become an important tool for change, for developing, to making sure that we are always improving and learning for the benefit of the stakeholders.

Topic 4.2 Global Regulatory Environment

There are some legal and regulatory issues in different countries that will affect growth of Islamic finance and banking.

The signals countries send to people, to investors in terms of changes specifically in taxation impact on the Islamic finance and banking market opportunities.

Understandably lawmakers, governments and finance regulators are mainly trying to protect the customer and the community against unfair businesses and unfair business practices.

Islamic finance and banking also aims to protect the customer and community. When people better understand Islamic finance and banking they will appreciate the positive approach of the sector for the community and business.

Topic 4.3 Law, Shariah & Business

This link between the law, Shariah and business is always important to understand.

How the government regulates and does something, will highlight the approach and incentives for Islamic finance that will filter down to the business community and general community.

Business run along Islamic lines and Shariah work on the principle that it only prohibits things that have a detrimental impact on society, business and the community.

Shariah is trying to get out of the way and remove all of the issues that might cause harm to the community and leave you with a level playing field where you can compete, to be the best, and the most useful to everybody.

There is the global opportunity for western governments and law makers to remove the barriers, artificial barriers that will open more Islamic finance investment, more opportunities and associated growth that will in term support greater business and so on.

The opportunity is to create a finance environment that benefits everybody and is supported by the laws of the land, open minded people can embrace, and it benefits the economy and community.

Topic 4.4 Next Steps

There is much current development and future opportunity and growth in Islamic Finance globally.

Topic 4.5 Close & Feedback

This course has been designed to benefit everybody, from Muslims to Non-Muslims, and also regulators and law makers interested in ensuring their systems are relevant and can work with the development of Islamic finance and Shariah compliant principles.

The growing global trend and development of global Islamic finance is an international opportunity.

The services are available to everybody, the approaches available to everybody, and the benefits aim to benefit everybody.

The key focus of this course is to help people better understand Islamic Finance and how to ensure ethical and honest mutually beneficial relationships and transactions.

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| **FEEDBACK: We welcome feedback on the course content or ideas**  **to ensure this course is available to all globally. Please email:** [**partner@edgyglobal.com**](mailto:partner@edgyglobal.com) |



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