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Principles and Development of Islamic Finance

Islamic finance is a rapidly growing part of the financial sector in the world. Indeed, it is not restricted to Islamic countries and is spreading wherever there is a sizable Muslim community. More recently, it has caught the attention of conventional financial markets as well. According to some estimates, more than 250 financial institutions in over 45 countries practice some form of Islamic finance, and the industry has been growing at a rate of more than 15 percent annually for the past five years. The market's current annual turnover is estimated to be $350 billion, compared with a mere $5 billion in 1985.[1] Since the emergence of Islamic banks in the early 1970s, considerable research has been conducted, focusing mainly on the viability, design, and operation of "deposit-accepting" financial institutions, which function primarily on the basis of profit- and loss-sharing partnerships rather than the payment or receipt of interest, a prohibited element in Islam.

Whereas the emergence of Islamic banks in global markets is a significant development, it is dwarfed by the enormous changes taking place in the conventional banking industry. Rapid innovations in financial markets and the internationalization of financial flows have changed the face of conventional banking almost beyond recognition. Technological progress and deregulation have provided new opportunities, increasing competitive pressures among banks and non-banks alike. The growth in international financial markets and the proliferation of diverse financial instruments have provided large banks with wider access to funds. In the late 1980s, margins attained from the traditional business of banking diminished. Banks have

Key Messages

- Institutions offering financial instruments and services compatible with the principles of Islam are emerging rapidly in domestic and international financial markets.
- The basic framework for an Islamic financial system is a set of rules and laws, collectively referred to as *Shariah*, governing economic, social, political, and cultural aspects of Islamic societies.
- Prohibition of *riba* —a term literally meaning "an excess" and interpreted as "any unjustifiable increase of capital whether in loans or sales"—is the central tenet of the system. Such prohibition is applicable to all forms of "interest" and therefore eliminates "debt" from the economy.
- Efforts to develop financial intermediation without interest started in the 1960s. Several Islamic banks were established in the 1970s, and their number has been growing since then.
- The last decade has witnessed rapid developments in the areas of financial innovation, risk management, regulation, and supervision.

responded to these new challenges with vigor and imagination by forging ahead into new arenas. At the same time, markets have expanded, and opportunities to design new products and provide more services have arisen. While these changes have occurred more quickly in some countries than in others, banks everywhere are developing new instruments, products, services, and techniques. Traditional banking practice—based on the receipt of deposits and the granting of loans—is only one part of a typical bank's business today and often the least profitable.

New information-based activities, such as trading in financial markets and generating income through fees, are now a major source of a bank's profitability. Financial innovation has also led to the increased market orientation and marketability of bank assets, which entail the use of assets such as mortgages, automobile loans, and export credits as backing for marketable securities, a process known as securitization. A prime motivation for innovation has been the introduction of prudential capital requirements, which has led to a variety of new financial instruments. Some instruments are technically very complicated and poorly understood except by market experts, while many others pose complex problems for the measurement, management, and control of risk. Moreover, profits associated with some of these instruments are high and, like the financial markets from which they are derived, are highly volatile and expose banks to new or higher degrees of risk.

These developments have increased the need for and complicated the function of risk measurement, management, and mitigation (control

assessment). The quality of corporate governance of banks has become a hot topic, and the approach to regulation and supervision has changed dramatically. Within an individual bank, the new banking environment and increased market volatility have necessitated an integrated approach to asset-liability and risk management.

Rapid developments in conventional banking have also influenced the reshaping of Islamic banks and financial institutions. There is a growing realization among Islamic financial institutions that sustainable growth requires the development of a comprehensive risk management framework geared to their particular situation and requirements. At the same time, policy makers and regulators are taking serious steps to design an efficient corporate governance structure as well as a sound regulatory and supervisory framework to support development of a financial system conducive to Islamic principles.

This publication provides a comprehensive overview of topics related to the assessment, analysis, and management of various types of risks in the field of Islamic banking. It is an attempt to provide a high-level framework (aimed at non-specialist executives) attuned to the current realities of changing economies and Islamic financial markets. This approach emphasizes the accountability of key players in the corporate governance process in relation to the management of Islamic financial risk.

PRINCIPLES OF ISLAMIC FINANCIAL SYSTEMS

The Islamic financial system is not limited to banking; it also covers capital formation, capital markets, and all types of financial intermediation and risk transfer. The term "Islamic financial system" is relatively new, appearing only in the mid-1980s. In fact, earlier references to commercial or mercantile activities conforming to Islamic principles were made under the umbrella of either "interest-free" or "Islamic" banking. However, interpreting the Islamic financial system simply as free of interest does not capture a true picture of the system as a whole. Undoubtedly, prohibiting the receipt and payment of interest is the nucleus of the system, but it is supported by other principles of Islamic doctrine advocating social justice, risk sharing, the rights and duties of individuals and society, property rights, and the sanctity of contracts.

An Islamic economic system is a rule-based system formulated by Islamic law, known as *Shariah*. The *Shariah* consists of constitutive and regulative rules according to which individual Muslims, and their collectivity, must conduct their affairs. The basic source of the law, in Islam, is the Qur'an, whose centrality in Islam and influence on the life of Muslims

cannot be overemphasized. Its chapters constitute the tissues out of which the life of a Muslim is tailored, and its verses are the threads from which the essence of his or her soul is woven. It includes all the necessary constitutive rules of the law as "guidance for mankind." However, it contains many universal statements that need further explanation before they can become specific guides for human action. Hence, after the *Qur'an*, the Prophet Muhammad's sayings and actions are the most important sources of the law and a fountainhead of Islamic life and thought.

The philosophical foundation of an Islamic financial system goes beyond the interaction of factors of production and economic behavior. Whereas the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, which seek to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work ethic, distribution of wealth, social and economic justice, and role of the state. The Islamic financial system is founded on the absolute prohibition of the payment or receipt of any predetermined, guaranteed rate of return. This closes the door to the concept of interest and precludes the use of debt-based instruments.

Given an understanding of the role of institutions, rules, the law, and ideology of Islam, one can make the following propositions regarding the economic system:[2]

- The foremost priority of Islam and its teaching on economics is *justice and equity*. The notion of justice and equity, from production to distribution, is deeply embedded in the system. As an aspect of justice, social justice in Islam consists of the creation and provision of equal opportunities and the removal of obstacles equally for every member of society. Legal justice, too, can be interpreted as meaning that all members of society have equal status before the law, equal protection of the law, and equal opportunity under the law. The notion of economic justice, and its attendant concept of distributive justice, is characteristic of the Islamic economic system: rules governing permissible and forbidden economic behavior on the part of consumers, producers, and government, as well as questions of property rights and the production and distribution of wealth, are all based on the Islamic concept of justice.
- The Islamic paradigm incorporates a spiritual and moral framework that values human relations above material possessions. In this way, it not only is concerned about material needs but also establishes a balance between the material and spiritual fulfillment of human beings.

- Whereas conventional thinking focuses on the individual, society, or community and appears as a mere aggregate having no independent significance, the Islamic system creates a balanced relationship between the individual and society. Self-interest and private gains of the individual are not denied, but they are regulated for betterment of the collectivity. Maximizing an individual's pursuit of profit in enterprise or satisfaction in consumption is not the sole objective of society, and any wasteful consumption is discouraged.
- The recognition and protection of the property rights of all members of society are the foundation of a stakeholder-oriented society, preserving the rights of all and reminding them of their responsibilities.

To assure justice, the *Shariah* provides a network of ethical and moral rules of behavior for all participates in the market and requires that these norms and rules be internalized and adhered to by all (see box 1.1). This concept of market is based on the basic principle forbidding any form of behavior leading to the creation of instantaneous property rights without commensurate equity created by work. In this context, market imperfection refers to the existence of any factor considered not to be permissible by the *Shariah*, such as fraud, cheating, monopoly practices, coalitions and all types of combinations among buyers and sellers, underselling, speculative hoarding, and bidding up of prices without the intention to purchase. The freedom of contract and obligation to fulfill it, consent of the parties to a transaction, full access to the market for all buyers and sellers, honesty in transactions, and provision of full information regarding the quantity, quality, and prices of factors and products to buyers and sellers before the start of negotiation and bargaining are prescribed.

Beginning with the notion of property as a sacred trust, as well as prohibitions also present in other monotheistic religions, *Shariah* protects property from any exploitation through unjust and unfair dealings. Prohibition of *riba* (interest), elimination of *gharar* (contractual ambiguity), and restrictions on other forms of exploitation are some of the implications of this core principle. (See appendix A for a glossary of Islamic terms.) The significance of contracts and the related obligations cannot be overstated. In this context, financial transactions are no different from any other set of contracts subject to compliance with *Shariah* principles. Primarily, a financial transaction is considered valid if it meets the basic requirements of a valid legal contract and does not contain certain elements, such as *riba*, *gharar*, *qimar* (gambling), and *maysur* (games of chance involving deception). While the prohibition of *riba* is the most

BOX 1.1 Principles of an Islamic Financial System

The basic framework for an Islamic financial system is a set of rules and laws, collectively referred to as *Shariah*, governing economic, social, political, and cultural aspects of Islamic societies. *Shariah* originates from the rules dictated by the *Qur'an* and its practices and explanations rendered (more commonly known as *Sunnah*) by the Prophet Muhammad. Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the *Qur'an* and Sunnah. The basic principles of an Islamic financial system can be summarized as follows.

Prohibition of interest. Prohibition of *riba*—a term literally meaning "an excess" and interpreted as "any unjustifiable increase of capital whether in loans or sales"—is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (that is, guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of "interest" as widely practiced. This prohibition is based on arguments of social justice, equality, and property rights. Islamic law encourages the earning of profits but forbids the charging of interest because profits, determined ex post, symbolize successful entrepreneurship and creation of additional wealth, whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of accumulating and distributing wealth in the economy be fair and representative of true productivity.

Money as "potential" capital. Money is treated as "potential" capital—that is, it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is "potential" capital.

Risk sharing. Because interest is prohibited, suppliers of funds become investors instead of creditors. The provider of financial capital and the entrepreneur share business risks in return for a share of the profits. The terms of financial transactions need to reflect a symmetrical risk-return distribution that each party to the transaction may face. The relationship between the investors and the financial intermediary is based on profit- and loss-sharing principles, and the financial intermediary shares the risks with the investors.

Prohibition of speculative behavior. An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.

Sanctity of contracts. Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.

Shariah-approved activities. Only those business activities that do not violate the rules of *Shariah* qualify for investment. For example, any investment in business dealing with alcohol, gambling, or casinos is prohibited.

Social justice. In principle, any transaction leading to injustice and exploitation is prohibited. A financial transaction should not lead to the exploitation of any party to the transaction. Exploitation entails the absence of information symmetry between parties to a contract.

critical and gets the most attention, one cannot dispute the criticality of *gharar* and other elements. Historically, jurists or *Shariah* scholars did not interfere unnecessarily in economic activities and gave economic agents full freedom to contract as long as certain basic requirements—that is, the prohibition of *riba*—were met.

Prohibition of interest is not due to any formal economic theory as such but is directly prohibited by the divine order in the *Qur'an*. Verses of the *Qur'an* clearly prohibit dealing with *riba* but do not define it precisely. Such omission is often attributed to the fact that the concept was not vague at the time of prohibition, so there was no need to provide a formal definition. Defining the term in any language other than Arabic adds further complexity. For example, no single English word captures the essence of *riba*. This has caused much of the confusion in explaining the concept both to the lay person and to scholars.

Literally, the Arabic term *riba* refers to excess, addition, and surplus, while the associated verb implies "to increase, to multiply, to exceed, to exact more than was due, or to practice usury." E. W. Lane's Arabic-English Lexicon presents a comprehensive meaning that covers most of the earlier definitions of *riba*:[3]

> To increase, to augment, swellings, forbidden "addition," to make more than what is given, the practicing or taking of usury or the like, an excess or an addition, or an addition over and above the principal sum that is lent or expended.

While the original basis for the prohibition of interest was divine authority, Muslim scholars recently have emphasized the lack of a theory to justify the use of interest. Muslim scholars have rebutted the arguments that interest is a reward for savings—a productivity of capital—and constitutes the difference between the value of capital goods today and their value tomorrow. Regarding interest being a reward for savings, they argue that interest could be justified only if it resulted in reinvestment and subsequent growth in capital and was not a reward solely for forgoing consumption. Regarding interest as productive capital, modern Muslim scholars argue that the interest is paid on the money and is required regardless of whether or not capital is used productively and thus is not justified. Finally, regarding interest as an adjustment between the value of capital goods today and their value tomorrow, they argue that this only explains its inevitability and not its rightness: if that is the sole justification for interest, it seems more reasonable to allow next year's

economic conditions to determine the extent of the reward, as opposed to predetermining it in the form of interest (Mirakhor 1989).

After *riba*, contractual ambiguity is the most important element in financial contracts. In simple terms, *gharar* refers to any uncertainty created by the lack of information or control in a contract. It can be thought of as ignorance in regard to an essential element in a transaction, such as the exact sale price or the ability of the seller to deliver what is sold. The presence of ambiguity makes a contract null and void.

Gharar can be defined as a situation in which either party to a contract has information regarding some element of the subject of the contract that is withheld from the other party or in which neither party has control over the subject of the contract. Classic examples include transactions involving birds in flight, fish not yet caught, an unborn calf in its mother's womb, or a runaway animal. All such cases involve the sale of an item that may or may not exist. More modern examples include transactions whose subject is not in the possession of one of the parties and over which there is uncertainty even about its future possession.

Keeping in mind the notion of fairness in all Islamic commercial transactions, *Shariah* considers any uncertainty as to the quantity, quality, recoverability, or existence of the subject matter of a contract as evidence of *gharar*. However, *Shariah* allows jurists to determine the extent of *gharar* in a transaction and, depending on the circumstances, whether it invalidates the contract. By prohibiting *gharar*, *Shariah* prohibits many pre-Islamic contracts of exchange, considering them subject to either excessive uncertainty or opaqueness to one or both parties to the contract. In many cases, *gharar* can be eliminated simply by stating the object of sale and the price. A well-documented contract eliminates ambiguity as well.

Considering *gharar* as excessive uncertainty, one can associate it with the element of "risk." Some argue that prohibiting *gharar* is one way of managing risks in Islam, because a business transaction based on the sharing of profit and loss encourages parties to conduct due diligence before committing to a contract. Prohibition of *gharar* forces parties to avoid contracts with a high degree of informational asymmetry and with extreme payoffs; it also makes parties more responsible and accountable. Treating *gharar* as risk may preclude the trading of derivative instruments, which is designed to transfer risks from one party to another.

Another area where prohibition of *gharar* has raised concerns in contemporary financial transactions is the area of insurance. Some argue that

writing an insurance (*takaful*) contract on the life of a person falls within the domain of *gharar* and thus invalidates the contract. The issue is still under review and not fully resolved.

DEVELOPMENT AND GROWTH OF ISLAMIC FINANCE

Islamic finance was practiced predominantly in the Muslim world throughout the Middle Ages, fostering trade and business activities with the development of credit. Islamic merchants in Spain, the Mediterranean, and the Baltic states became indispensable middlemen for trading activities. In fact, many concepts, techniques, and instruments of Islamic finance were later adopted by European financiers and businessmen.

An interest in the Islamic mode of banking emerged in several Muslim countries during the postcolonial era as part of an effort to revive and strengthen an Islamic identity. Independent but parallel attempts in Egypt and Malaysia led to the establishment of financial institutions in the early 1960s that were designed to operate on a non-interest basis so as to comply with Islamic economic principles.[4] The first wave of oil revenues in the 1970s and the accumulation of petrodollars gave momentum to this idea, and the growth of Islamic finance coincided with the current account surpluses of oil-exporting Islamic countries. The Middle East saw a mushrooming of small commercial banks competing for surplus funds. At the same time, interest grew in undertaking theoretical work and research to understand the functioning of an economic and banking system without the institution of "interest." The first commercial bank was established in 1974 in the United Arab Emirates, followed by establishment of the Islamic Development Bank in 1975.

Western analysts quickly challenged the feasibility of a financial system operating without interest and debt. Here, we summarize their arguments in six propositions:[5]

- Zero interest would mean infinite demand for loanable funds and zero supply.
- Such a system would be incapable of equilibrating demand for and supply of loanable funds.
- Zero interest would mean no savings.
- Zero savings would mean no investment and no growth.
- There could be no monetary policy since instruments for managing liquidity could not exist without a predetermined, fixed rate of interest.
- In countries adopting such a system, there would be one-way capital flight.

By 1988 these arguments were countered when research, based on modern financial and economic theory, showed the following:

- A modern financial system can be designed without the need for an ex ante positive nominal fixed interest rate. In fact, as Western researchers showed, no satisfactory theory could explain the need for an ex ante positive nominal interest rate.
- The failure to assume an ex ante positive nominal fixed interest rate—that is, no debt contract—does not necessarily mean that there has to be zero return on capital.
- The return on capital is determined ex post, and the magnitude of the return on capital is determined on the basis of the return to the economic activity in which the funds are employed.
- The expected return is what determines investment.
- The expected rate of return—and income—is what determines savings. Therefore, there is no justification for assuming that there will be no savings or investment.
- Positive growth is possible in such a system.
- Monetary policy would function as in the conventional system, its efficacy depending on the availability of instruments designed to manage liquidity.
- Finally, in an open-economy macroeconomic model without an ex ante fixed interest rate, but with returns to investment determined ex post, the assumption of a one-way capital flight is not justified.

Therefore, a system that prohibits an ex ante fixed interest rate and allows the rate of return on capital to be determined ex post, based on returns to the economic activity in which the funds are employed, is theoretically viable.

In the process of demonstrating the analytical viability of such a system, research also clearly differentiated it from the conventional system. In the conventional system, which is based on debt contracts, risks and rewards are shared asymmetrically, with the debtor carrying the greatest part of the risk and with governments enforcing the contract. Such a system has a built-in incentive structure that promotes moral hazard and asymmetric information. It also requires close monitoring, which can be delegated to an institution acting on behalf of the collectivity of depositors and investors; hence the need for banking institutions.

In the late 1970s and early 1980s, it was shown, mostly by Minsky (1982), that such a system is inherently prone to instability because there will always be maturity mismatch between liabilities (short-term deposits)

and assets (long-term investments). Because the nominal value of liabilities is guaranteed, while the nominal value of assets is not, when the maturity mismatch becomes a problem, banks will attempt to manage liabilities by offering higher interest rates to attract more deposits. There is always the possibility that this process will not be sustainable but instead will erode confidence and lead to a run on banks. Such a system, therefore, needs a lender of last resort and bankruptcy procedures, restructuring processes, and debt workout procedures to mitigate the contagion.

During the 1950s and 1960s, Lloyd Metzler of the University of Chicago proposed an alternative system in which contracts are based on equity rather than debt and in which the nominal value of liabilities is not guaranteed, since this is tied to the nominal value of assets.[6] Metzler showed that such a system does not have the instability characteristic of the conventional banking system. In his now classic article, Mohsin Khan showed the affinity of Metzler's model with Islamic finance (Khan 1987). Using Metzler's basic model, Khan demonstrated that this system produces a saddle point and is, therefore, more stable than the conventional system.

By the early 1990s, it was clear that an Islamic financial system not only is theoretically viable, but also has many desirable characteristics. The phenomenal growth of Islamic finance during the 1990s demonstrated the empirical and practical viability of the system (see table 1.1).

The 1980s proved to be the beginning of a period of rapid growth and expansion of the Islamic financial services industry. This growth became steady through the 1990s. The major developments of the 1980s include continuation of serious research at the conceptual and theoretical level, constitutional protection in three Muslim countries, and the involvement of conventional bankers in offering *Shariah*-compliant services. The Islamic Republic of Iran, Pakistan, and Sudan announced their intention to make their financial systems compliant with *Shariah*. Other countries such as Bahrain and Malaysia introduced Islamic banking within the framework of the existing system. The International Monetary Fund (IMF) initiated research in understanding the macroeconomic implications of an economic system operating without the concept of interest. Similar research was conducted to understand the issues of profit- and loss-sharing partnership contracts and the financial stability of such a system.

During the early growth of Islamic financial markets in the 1980s, Islamic banks faced a dearth of quality investment opportunities, which created business opportunities for the conventional Western banks to act as intermediaries, deploying Islamic banks' funds according to guidelines provided by the Islamic banks. Western banks helped Islamic banks to place

TABLE 1.1 Development of Islamic Economics and Finance in Modern History

Time period	*Development*
Pre-1950s	• Barclays Bank opens its Cairo branch to process financial transactions related to construction of the Suez Canal in the 1890s. Islamic scholars challenge the operations of the bank, criticizing it for charging interest. This criticism spreads to other Arab regions and to the Indian subcontinent, where there is a sizable Muslim community. • The majority of *Shariah* scholars declare that interest in all its forms amounts to the prohibited element of *riba*.
1950s–60s	• Initial theoretical work in Islamic economics begins. By 1953, Islamic economists offer the first description of an interest-free bank based on either two-tier *mudarabah* (profit- and loss-sharing contract) or *wakalah* (unrestricted investment account in which the Islamic bank earns a flat fee). • Mitghamr Bank in Egypt and Pilgrimage Fund in Malaysia start operations.
1970s	• The first Islamic commercial bank, Dubai Islamic Bank, opens in 1974. • The Islamic Development Bank (IDB) is established in 1975. • The accumulation of oil revenues and petrodollars increases the demand for *Shariah*-compliant products.
1980s	• The Islamic Research and Training Institute is established by the IDB in 1981. • Banking systems are converted to an interest-free banking system in the Islamic Republic of Iran, Pakistan, and Sudan. • Increased demand attracts Western intermediation and institutions. • Countries like Bahrain and Malaysia promote Islamic banking parallel to the conventional banking system.
1990s	• Attention is paid to the need for accounting standards and a regulatory framework. A self-regulating agency, the Accounting and Auditing Organization of Islamic Financial Institutions, is established in Bahrain. • Islamic insurance (*takaful*) is introduced. • Islamic equity funds are established. • The Dow Jones Islamic Index and the FTSE Index of *Shariah*-compatible stocks are developed.
2000–the present	• The Islamic Financial Services Board is established to deal with regulatory, supervisory, and corporate governance issues of the Islamic financial industry. • *Sukuks* (Islamic bonds) are launched. • Islamic mortgages are offered in the United States and United Kingdom.

Source: Khan (1996); IDB (2005).

funds in commerce and trade-related activities by arranging a trader to buy goods on behalf of the Islamic bank and resell them at a markup. Gradually, Western banks recognized the importance of the emerging Islamic financial markets and started to offer Islamic products through "Islamic

windows" in an attempt to attract clients directly. Islamic windows are not independent financial institutions; rather, they are specialized setups within conventional financial institutions that offer *Shariah*-compliant products. Meanwhile, due to the growing demand for *Shariah*-compliant products and fear of losing depositors, non-Western conventional banks also started to offer Islamic windows. In general, Islamic windows are targeted at high-net-worth individuals who want to practice Islamic banking: approximately 1–2 percent of the world's Muslim population.

The number of conventional banks offering Islamic windows is growing, as several leading conventional banks, such as the Hong Kong and Shanghai Banking Corporation (HSBC), are pursuing this market very aggressively. HSBC has a well-established network of banks in the Muslim world and, in 1998, launched HSBC Global Islamic Finance with the objective of promoting Islamic asset securitization, private equity, and banking in the industrial countries. The list of Western banks keeping Islamic windows includes, among others, ABN Amro, American Express Bank, ANZ Grindlays, BNP-Paribas, Citicorp Group, and Union Bank of Switzerland (UBS). The leading non-Western banks with a significant presence of Islamic windows are National Commercial Bank of Saudi Arabia, United Bank of Kuwait, and Riyadh Bank. Citibank is the only Western bank to have established a separate Islamic bank: Citi Islamic Investment Bank (Bahrain) in 1996.

By the early 1990s, the market had gained enough momentum to attract the attention of public policy makers and institutions interested in introducing innovative products. The following are some of the noteworthy developments.

Recognizing the need for standards, a self-regulatory agency—the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)—was established. AAOIFI was instrumental in highlighting the special regulatory needs of Islamic financial institutions. AAOIFI defined accounting and *Shariah* standards, which were adopted or recognized by several countries. However, as the market grew, the regulatory and supervisory authorities, with the help of the IMF, established a dedicated regulatory agency, the Islamic Financial Services Board (IFSB), in the early 2000s to address systemic stability and various governance and regulatory issues relating to the Islamic financial services industry. IFSB took on the challenge and started working in the area of regulation, risk management, and corporate governance.

Further progress was made in developing capital markets. Islamic asset-backed certificates, *sukuks*, were introduced in the market. Different structures of *sukuks* were launched successfully in Bahrain, Malaysia, and

other financial centers. Among the issuers were corporations, multilaterals, and sovereign entities such as the Islamic Development Bank, the International Bank for Reconstruction and Development (World Bank), and the governments of Bahrain, Pakistan, and Qatar. During the equities market boom of the 1990s, several equity funds based on *Shariah*-compatible stocks emerged. Dow Jones and Financial Times launched Islamic indexes to track the performance of Islamic equity funds.

Several institutions were established to create and support a robust financial system, including the International Islamic Financial Market, the International Islamic Rating Agency, the General Council of Islamic Banks and Financial Institutions, and the Arbitration and Reconciliation Centre for Islamic Financial Institutions. Today, Islamic finance is no stranger to leading financial centers of the world. With the recent wave of high oil revenues in the Middle East, demand for *Shariah*-compliant products on both the buy and sell sides has increased sharply. It is expected that as leading market makers embrace and begin to practice Islamic finance, the market will grow further, and new products and services will be introduced in the near future.

NOTES

1. A billion is 1,000 million.
2. For further details see Mirakhor (1989); Iqbal and Mirakhor (2007).
3. www.study.quran.co.uk/LLhome.htm.
4. In Malaysia, a pilgrimage fund was established in the late 1950s to facilitate savings to pay for the pilgrimage trip to Makkah. The Pilgrimage Fund became a full-fledged interest-free investment bank in 1962. Around the same time, a cluster of small interest-free savings banks emerged in northern rural Egypt, starting in Mitghamr in 1963.
5. For further details, see Iqbal and Mirakhor (2007).
6. See http://cepa.newschool.edu/het/profiles/metzler.htm.

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Theory and Practice of Islamic Financial Intermediation

Financial systems are crucial for the efficient allocation of resources in a modern economy. Their landscape is determined by the nature of financial intermediation—that is, how the function of intermediation is performed and who intermediates between suppliers and users of the funds. The acquiring and processing of information about economic entities, the packaging and repackaging of financial claims, and financial contracting are common elements that differentiate financial intermediation from other economic activities.

The main functions of a financial intermediary are asset transformation, conduct of orderly payments, brokerage, and risk transformation. Asset transformation takes place in the form of matching the demand for and supply of financial assets and liabilities (for example, deposits, equity, credit, loans, and insurance) and entails transformation of the maturity, scale, and location of the financial assets and liabilities of the ultimate borrowers and lenders. The administration of an accounting and payment system (for example, check transfer, electronic funds transfer, settlement, clearing) is another important function of intermediation. Typically, financial intermediaries also offer pure brokerage or matchmaking between borrowers and lenders and facilitate the demand for and supply of intangible and contingent assets and liabilities, such as collateral, guarantees, financial advice, and custodial services.

Financial intermediaries not only channel resources from capital-surplus agents (generally households) to capital-deficit ones (businesses) but also allow intertemporal smoothing of households' consumption and businesses' expenditures, enabling both firms and households to share

Key Messages

- The Islamic financial system is based on a set of contracts. These contracts include contracts for real economic activities, financing, intermediation, and social welfare.
- The *mudarabah* (trust financing) contract is the cornerstone of financial intermediation by Islamic banks. The owner of capital (depositors) forms a partnership with a manager (financial intermediary) on a profit- and loss-sharing basis.
- Both the assets and liabilities side of an Islamic bank balance sheet are based on *Shariah*-compatible financial instruments. Depositors are considered investors and are known as investment account holders.
- The assets of Islamic banks consist of trade financing, commodity trading, leasing, partnerships, and equity-based partnerships.
- Islamic products are offered by dedicated Islamic banks and several non-Islamic banks through special "Islamic windows."
- The number of Islamic investment banks, mortgage companies, Islamic insurance (*takaful*), and Islamic funds is growing.

risks. Increased financial market complexity and volatility have led financial intermediaries to offer products that mitigate, transfer, and share financial risks. Other factors stimulating financial innovations are the liberation of capital accounts, deregulation, and breakthroughs in technology.

Financial intermediation in Islamic history has an established historical record and has made significant contributions to economic development over time. Financiers in the early days of Islam—known as *sarrafs*—undertook many of the traditional, basic functions of a conventional financial institution, such as intermediation between borrowers and lenders, operation of a secure and reliable domestic as well as cross-border payment system, and provision of services such as the issuance of promissory notes and letters of credit. Commercial historians have equated the function of *sarrafs* with that of banks. Historians like Udovitch consider them to have been "bankers without banks" (Udovitch 1981). *Sarrafs* operated through an organized network and well-functioning markets, which established them as sophisticated intermediaries, given the tools and technology of their time. It is claimed that financial intermediaries in the early Islamic period also helped one another to overcome liquidity shortages on the basis of mutual help arrangements. There is evidence that some of the legal concepts, contracts, practices, and institutions developed in the late eighth century provided the foundations for similar instruments in Europe several centuries later (Chapra and Khan 2001).

The *Shariah* provides a set of *intermediation contracts* that facilitate an efficient and transparent execution and financing of economic activities. This set of contracts is comprehensive enough to provide a wide range of typical intermediation services such as asset transformation, a payment system, custodial services, and risk management. Intermediation contracts can be classified into three groups. The first is the most significant: it deals with intermediation through the formation of a partnership of capital and entrepreneurial skills. The second group, which is based on the concept of trust, deals with the placement of assets in the hand of intermediaries for the sake of protection or security. The third group facilitates explicit and implicit guarantees of financial performance between economic agents. These contracts play a critical role by providing stability and mitigating risk in the financial system.

STRUCTURE OF FINANCIAL STATEMENTS

For Islamic financial institutions, the nature of financial intermediation, including the function of banking, is different from that of conventional financial institutions. This difference is the key to understanding the difference in the nature of risks in conventional and Islamic banking. For Islamic banks, the *mudarabah* contract is the cornerstone of financial intermediation and thus of banking. In a *mudarabah* contract, the owner of capital forms a partnership with an entrepreneur or manager who has certain business skills, and both agree to share the profits and losses of the venture undertaken. Such a contract can be applied by an Islamic bank to raise funds in the form of deposits as well as to deploy funds on the assets side.

The basic concept is that both the mobilization and (in theory) the use of funds are based on some form of profit sharing among the depositors, the bank, and the entrepreneurs (users of funds). A typical Islamic bank performs the functions of financial intermediation by screening profitable projects and monitoring the performance of projects on behalf of the investors who deposit their funds with the bank.

Table 2.1 presents a stylized balance sheet of an Islamic bank, displaying different activities and financial instruments. It serves as a good starting point for understanding the dynamics of the risks inherent in Islamic banks. Panel A classifies both assets and liabilities based on the maturity profile of different instruments. Although some instruments, such as *ijarah* and *istisnah*, can be used across different maturity groups, this demarcation is based on the most common use of the instruments. Panel B provides an alternative view based on the functionality and purpose of

TABLE 2.1 A Theoretical Balance Sheet of an Islamic Bank Based on Maturity Profile

Assets	*Liabilities*
Based on maturity profile	
Short-term trade finance (cash, *murabahah*, *salaam*)	Demand deposits (*amanah*)
Medium-term investments (*ijarah*, *istisnah*)	Investment accounts (*mudarabah*)
Long-term partnerships (*musharakah*)	Special investment accounts (*mudarabah*, *musharakah*)
Fee-based services (*joalah*, *kifalah*, and so forth)	Reserves
Non-banking assets (property)	Equity capital

TABLE 2.1 B Theoretical Balance Sheet of an Islamic Bank Based on Functionality

Assets	*Liabilities*
Based on functionality	
Cash balances	Demand deposits (*amanah*)
Financing assets (*murabahah*, *salaam*, *ijarah*, *istisnah*)	Investment accounts (*mudarabah*)
Investment assets (*mudarabah*, *musharakah*)	Special investment accounts (*mudarabah*, *musharakah*)
Fee-based services (*joalah*, *kifalah*, and so forth)	Reserves
Non-banking assets (property)	Equity capital

different instruments. Although several Islamic banks organize their financial statements on the basis of functionality, a maturity-based view of the balance sheet is important to keep in mind as it helps to understand exposure at the institutional level.

Liabilities

The liabilities side of the balance sheet is based on the "two-window" theoretical model of an Islamic bank. In addition to equity capital, this model divides the "liability" or funding side of the bank balance sheet into two deposit windows, one for demand deposits and the other for investment or special investment accounts. The choice of window is left to the depositors. Unlike conventional commercial banking, the investment accounts of an Islamic bank are not liabilities in a strict sense because depositors in a conventional bank create immediate claims on the bank, whereas investors-depositors in Islamic banks are like partners.

In addition, special or restricted investment accounts are often shown as off-balance-sheet funds under management. A 100 percent reserve is required for demand deposits (but no reserve requirement is

stipulated for the second window). This 100 percent requirement is based on the presumption that the money deposited as demand deposits is placed as *amanah* (demand deposits): they yield no returns and are repayable on demand and at par value; therefore, money creation through the multiplier effect is limited.

Money deposited in investment accounts, in contrast, is placed with the depositors' full knowledge that their deposits will be invested in risk-bearing projects; no guarantee is needed or justified. Investment account holders are investors or depositors who enter into a *mudarabah* contract with the bank, where investors act as the supplier of funds (*rab al-mal*) to be invested by the bank on their behalf, as the agent (*mudarib*). The investors share in the profits accruing to the bank's investments on the assets side. Therefore, such profit-sharing investment deposits are not liabilities. Investors' capital is not guaranteed, and they incur losses if the bank does; the form is closer to that of a limited-term, non-voting equity or a trust arrangement. Some Islamic banks also offer special investment accounts developed on the basis of a special-purpose or restricted *mudarabah* or on profit and loss sharing (*musharakah*). These special investment accounts, which are similar to close-end mutual funds, are highly customized and targeted toward high-net-worth individuals.

Assets

On the assets side, Islamic banks have more choice of instruments with different maturities and risk-return profiles. For short-term maturities, trade financing or financial claims resulting from a sales contract—that is, *murabahah*, *salaam*, and so forth—are available. For medium-term investments, leasing (*ijarah*), manufacturing contracts (*istisnah*), and various partnerships are possible; for long-term investments, partnerships in the form of *musharakah* can be undertaken. An Islamic financial intermediary may also engage an external entrepreneur on a *mudarabah* basis in which the bank acts as principal and the entrepreneur (user of the funds) acts as agent. In this capacity, an Islamic bank can form a syndicate with other financial or nonfinancial institutions to provide entrepreneurs with medium- to long-term capital. Finally, like any conventional bank, Islamic banks also provide customized services, guarantees, and underwriting services for a fee.

The risks of a financial intermediary can be better understood when the sources and applications of funds under management by the financial intermediary are viewed as subportfolios of distinct risk-return

and maturity profiles. Table 2.2 provides an overview of the sources and application of funds for a typical Islamic bank. The composition and mix of different maturity buckets on the assets side depend on each financial institution, which may select a mix to match its needs to those of its depositors.

BASIC CONTRACTS AND INSTRUMENTS

Contracts play a vital role in the Islamic financial system, and all financial transactions are based on contractual agreements. Figure 2.1 provides an overview of different contracts and their intended role in Islamic financial systems. Following is a brief explanation of select basic contracts serving as financial instruments classified by their functionality.

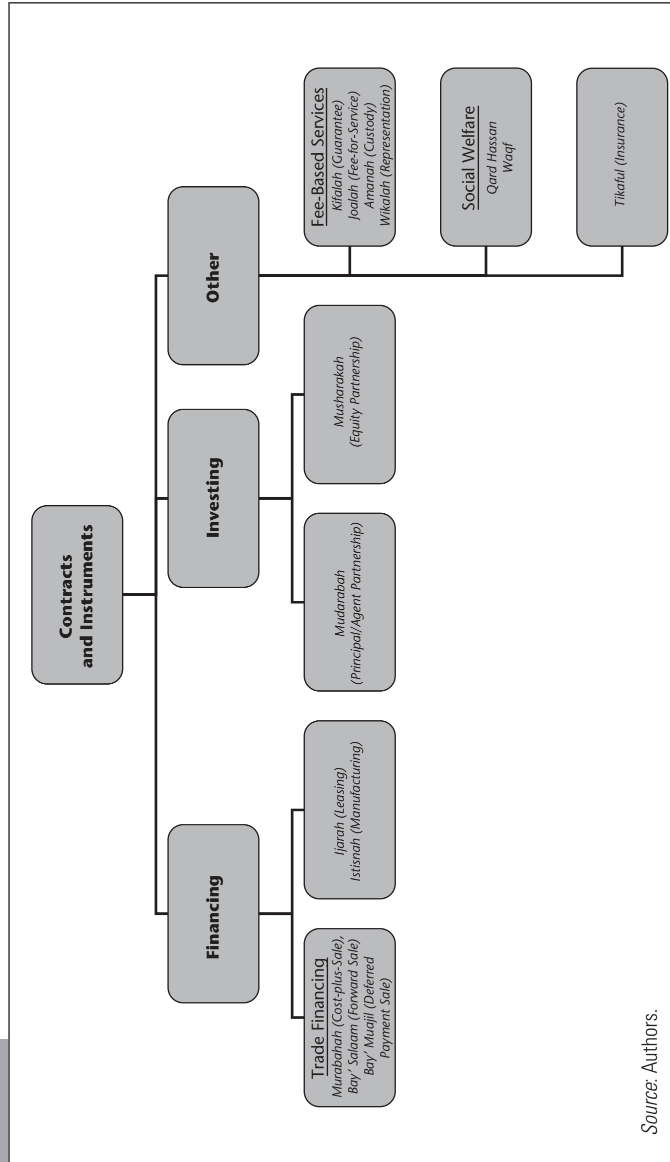
Financing Instruments

Financing instruments are used primarily to finance obligations arising from the trade and sale of commodities or property. Financing instruments also include instruments generating rental cash flows against exchange of rights to use the assets such as *ijarah* and *istisnah*. Financing instruments are closely linked to a sale contract and therefore are collateralized by the product being financed. These instruments are the basis of short-term assets for the Islamic banks. *Murabahah*, a cost-plus sales contract, is one of the most popular contracts for purchasing commodities and other products on credit. The concept is that a financier purchases a product—that is, a commodity, raw materials, and so forth—for an entrepreneur who does not have his or her own capital to do so. The financier and the entrepreneur agree on a profit margin, often referred to as markup, which is added to the cost of the product. The payment is delayed for a specified

TABLE 2.2 Sources and Application of Funds

Sources of funding (liabilities and equity)	*Application of funding (assets)*
Equity capital and shareholders' reserves	Short-term trade finance (*murabahah*, *salaam*)
Demand and safekeeping deposits (*amanah*)	Regulatory cash reserve requirement
	Medium-term investment (*ijarah*, *istisnah*)
Investment accounts (*mudarabah*)	Long-term partnerships (*musharakat*)
Special investment accounts (*mudarabah*, *musharakah*)	Fee-based services (*joalah*, *kifalah*, and so forth)

FIGURE 2.1 Contracts and Instruments



Source: Authors.

period of time during which the entrepreneur produces the final product and sells it in the market. To be a valid contract, *Shariah* requires that a *murabahah* contract be the result of an original sale and not a means of financing existing inventory. In addition, the financier must take ownership of the item on sale.

Murabahah was originally a sales transaction in which a trader would purchase a product and then sell it to the end user at a price calculated using an agreed profit margin over the costs incurred by the trader. Today, banks have taken over the trader's role of financier.

Bay al-muajjil, or sale with deferred payment, allows the sale of a product on the basis of a deferred payment in installments or a lump sum. The price of the product is agreed upon by the buyer and the seller at the time of the sale and cannot include any charges for deferring payments. *Bay' al-salaam,* or purchase with deferred delivery, is similar to conventional forward contracts in terms of function but is different in terms of the payment arrangements. In the case of *bay' al-salaam*, the buyer pays the seller the full negotiated price of a specific product that the seller promises to deliver at a specified future date. The main difference between *bay' al-salaam* and a conventional forward contract is that the full negotiated price is payable at the time of the contract, as opposed to the latter, where the full payment is not due in advance. This forward sale benefits both the seller and the buyer. The seller gets cash to invest in the production process, and the buyer eliminates uncertainty in the future price.

Several medium-term financing instruments are available: *ijarah* (a leasing contract) and *istisnah* (a manufacturing contract).

An *ijarah* contract gives something in return for rent. Technically, it is a contract of sale, but it is not the sale of a tangible asset; rather, it is a sale of the *usufruct* (right to use the object) for a specified period of time. The word *ijarah* conveys the sense of both hire and lease. In general, it refers to the lease of tangible assets such as property and merchandise, but it also denotes the hiring of personal services for a fee. Compared with the conventional form of financing, which is generally in the form of a debt, leasing provides financing in relation to a particular asset. In a sense, it combines financing and collateral, because the ownership of the asset serves as collateral and security against any future loss.

One of the major advantages of *ijarah* is that it resembles the conventional lease agreement. There are some differences between the two, but they function in largely the same way. One difference is that in *ijarah* the leasing agency must own the leased object for the duration of the lease. Another difference is the absence of compound interest that may be charged under conventional leases in the event of default or delay in

the installment payments. Similarities with conventional leasing make this contract attractive to conventional investors and borrowers as well.

An *istisnah* contract facilitates the manufacture or construction of an asset at the request of the buyer. Once the manufacturer undertakes to manufacture the asset or property for the buyer, the transaction of *istisnah* comes into existence. Both parties—namely, the buyer and the manufacturer—agree on a price and on the specification of the asset to be manufactured. At the time of delivery, if the asset does not conform to the specifications, the party placing the order has the right to retract the contract.

An important feature of *istisnah* relates to the mode and timing of payment. There is flexibility in regard to the payment, and it is not necessary for the price to be paid in advance. It is also not necessary for it to be paid at the time of delivery. Both parties can agree on a schedule of payment convenient to both, and the payment can be made in installments.

Like *ijarah*, *istisnah* has great potential for application in the area of project finance in different sectors and industries. Successful applications include the manufacture of aircraft, locomotives, ships, and heavy-duty machinery. The *istisnah* contract also is suitable for building infrastructure such as roads, dams, housing, hospitals, and schools.

Investing Instruments

Investing instruments are vehicles for capital investment in the form of a partnership. There are two types of investing instruments: fund management (*mudarabah*) and equity partnerships (*musharakah*).

Mudarabah, which can be short, medium, or long term, is a trust-based financing agreement whereby an investor entrusts capital to an agent to undertake a project. Profits are based on a prearranged, agreed ratio. A *mudarabah* agreement is akin to a Western-style limited partnership in which one party contributes capital, while the other runs the business; profit is distributed based on a negotiated percentage of ownership. The investor bears the loss, but the agent does not share in any financial loss unless there is evidence of misconduct or negligence. *Mudarabah* is used on both the liabilities and the assets side.

Musharakah, which can be either medium or long term, is a hybrid of *shiraka* (partnership) and *mudarabah*, combining the act of investment and management. In the absence of debt security, the *Shariah* encourages this form of financing. The *Shariah* is fairly comprehensive in defining different types of partnerships, in identifying the rights and obligations of the partners, and in stipulating the rules governing the sharing of profits and losses. *Musharakah* is a form of partnership in which

two or more persons combine either their capital or their labor, share the profits and losses, and have similar rights and liabilities. Within *musharakah* there are further subclassifications of partnerships with respect to the level of the partners' authority and obligations and the type of his or her contribution, such as management skills or goodwill.

ISLAMIC FINANCIAL INSTITUTIONS IN PRACTICE[1]

While early forms of Islamic financial institutions were highly concentrated in commercial banking activities, more diverse forms have emerged in the last two decades to cater to the demands of different segments of the market. Although the Islamic mode of banking has been mandated and adopted by the governments of the Islamic Republic of Iran, Pakistan, and Sudan, the supply of *Shariah*-compliant products has been led primarily by the private sector. In fact, private Islamic banks as a group are becoming some of the largest private sector financial institutions in the Islamic world, with growing networks through branches or subsidiaries. There is no standard way of grouping Islamic financial institutions, but based on the services rendered, today's Islamic financial institutions can be divided into the following broad categories: Islamic banks, Islamic windows, Islamic investment banks and funds, Islamic mortgage companies, Islamic insurance companies, and *mudarabah* companies.

Islamic Banks

Islamic banks represent the majority of Islamic financial institutions; they are spread around the globe in both the public and private sectors. Islamic banks typically are a hybrid of a conventional commercial bank and an investment bank and resemble a universal bank. After the state sponsorship of Islamic banking in the Islamic Republic of Iran, Pakistan, and Sudan, all commercial banks were transformed to comply with *Shariah* rules and principles. Islamic banks in other countries, especially in the Middle East, are in the private sector, where ownership is by shareholders in public companies, by holding companies, or by wealthy families or individuals. There are two major holding companies: Dar-al-Mal Islami Group and Al Barakah Group, which have an extended network of Islamic financial institutions.

Islamic banks have grown in numbers, but the average size of assets is still small compared with that of a conventional bank. No Islamic bank is on the list of the top 100 banks in the world. According to some estimates, more than 60 percent of Islamic banks have assets that are below the level

($500 million) that theoretical studies suggest as being the minimum to be viable. Aggregate assets of all Islamic banks are still less than those of any of the top 60 banks in the world. Finally, the size of assets of the largest Islamic bank amounts to a meager 1 percent of the assets of the largest bank in the world (see table 2.3).

Islamic Windows

As discussed in chapter 1, Islamic windows are specialized setups that offer *Shariah*-compliant products. During the 1980s, conventional Western banks acted as intermediaries, deploying funds according to guidelines defined by the Islamic banks. Western banks helped Islamic banks to place funds in commerce and trade-related activities by arranging for a trader to buy goods on behalf of the Islamic bank and to resell them at a markup. Gradually, Western banks began to offer Islamic products and to attract clients directly without having to use an Islamic bank as intermediary.

The number of conventional banks offering Islamic windows is growing. Hong Kong Shanghai Banking Corporation launched HSBC Global Finance in 1998, and numerous Western banks offer Islamic windows, including ABN Amro, American Express Bank, ANZ Grindlays, BNP Pariba, Citicorp Group, Morgan Stanley, and Union Bank of Switzerland (UBS).

Islamic Investment Banks and Funds

Islamic investment banks and investment funds emerged during the 1990s, when the market reached a threshold where large transactions and

TABLE 2.3 Size of Islamic Financial Institutions in 1999

Region	*Number of Islamic financial institutions*	*Average capital (US$ million)*	*Average assets (US$ million)*
South Asia	51	17	770
Africa	35	6	45
South East Asia	31	5	75
Middle East	47	116	2,204
Europe and the Americas	9	70	101
Asia and Australia	3	3	6
Total	176	42	839

Source: Kahf (1999).

investment banking became attractive. Whereas a typical Islamic bank's services are retail and consumer centered, Islamic investment banks are aiming to capitalize on large investment syndication, market-making, and underwriting opportunities. Islamic investment banks have been successful in developing innovative large-scale transactions for infrastructure financing in conjunction with conventional project finance for projects such as the Hub Power project in Pakistan.

Islamic investment funds are not new but are making a comeback after initial experimentation during which many of them did not survive. The 1990s witnessed real growth in Islamic funds, and by the start of the new millennium, there were more than 150 Islamic funds with a wide range of offerings, including equity (more than 85), commodity, leasing, and trade-related funds. Funds other than equity are considered to be low risk because of the nature of the underlying instrument. Both leasing and commodity funds provide investors a low return with minimum risk of loss. In the case of leasing, the fund is a securitized pool of lease contracts dealing with collateralized assets generating a steady stream of cash flow. Since a lease contract is more familiar to conventional bankers, lease funds have wider acceptability with conventional investors. Similarly, commodity funds have a short-term exposure in markets that are efficient and have developed forward markets, thus reducing the level of risk. In contrast, equity funds are similar to conventional mutual funds and are exposed to a higher degree of risk.

Islamic equity funds gained popularity during the 1990s when global equity markets experienced historical growth. Such funds are designed to ensure that equity stocks included in the fund are not only well diversified but also fully compliant with the *Shariah*'s guidelines. The selection of a stock goes through a strict screening or filtering process, which ensures that (a) the company's capital structure is predominantly equity based (only a limited proportion of debt is accepted in certain circumstances); (b) the nature of the business does not involve any prohibited activity such as gambling, interest-based transactions, and the production or consumption of alcohol, and (c) only a negligible portion of income is derived from interest on securities. Since the majority of Muslim countries do not have well-developed capital and stock markets, fund managers focus mostly on equity markets in the developed countries, where the domain of qualified stocks is limited, which constrains the opportunities to hold a well-diversified portfolio.

Dow Jones has recognized the significance and potential of Islamic equity funds by setting up an equity benchmark index—the Dow Jones Islamic Market Index (DJIM). DJIM tracks *Shariah*-compliant stocks from the 2,700 stocks in the Dow Jones Global Index. FTSE followed, announcing

its own version of an index to track the performance of stocks qualified for Islamic investment. During the boom in equity markets, several institutions arranged investment in *Shariah*-compliant stocks through the Internet, but the timing of launch was not ideal, as equity markets started to decline by the end of the 1990s. Nevertheless, there is still a great potential for Islamic funds to expand across the globe through new technology.

Islamic Mortgage Companies

Islamic mortgage companies are another recent development. Targeted at the housing market for Muslim communities in Western countries (Canada, United Kingdom, and United States) with developed conventional mortgage markets, four models of Islamic mortgage are currently in practice. The first model is based on the *ijarah* (lease) contract and is the closest to the structure of a conventional mortgage. The second model is based on equity partnership (diminishing *musharakah*), where the mortgagee (lender) and mortgagor (borrower) jointly share ownership, which over a period of time is transferred to the mortgagor, who buys shares of ownership by contributing each month toward buying out the mortgagee's share in the property. Return to the lender is generated out of the fair rental value of the property. The third model is based on *murabahah* (sales transaction) and is practiced in the United Kingdom, where the property transfer tax (stamp duty) discriminates against the *ijarah*- or *musharakah*-based mortgage. The fourth model is designed along the lines of cooperative societies, where members buy equity (*musharakah*) membership and help each other to purchase property from the pool of the society's funds. Recently, the U.S. agency Freddie Mac recognized the importance of Islamic mortgages and began to underwrite and securitize them. The chances of success for Islamic mortgages are bright in Western markets, where capital markets are liquid, transparent, and well regulated. In particular, there is great potential for Islamic mortgages in the North American markets, where there is a sizable Muslim community in the middle- and upper-income brackets.

Islamic Insurance Companies

The closest Islamic instrument to the contemporary system of insurance is *takaful*, which literally means mutual or joint guarantee. Typically, *takaful* is carried out in the form of solidarity *mudarabah*, where the participants agree to share their losses by contributing periodic premiums in the form of investments. They are then entitled to redeem the residual value of profits after fulfilling the claims and premiums. A critical difference between

contemporary insurance models and *takaful* is the participant's right to receive surplus profits. The participants in a given solidarity (that is, *takaful*) *mudarabah* have the right to share the surplus profits generated, but at the same time they are liable, in addition to the premiums, for amounts they have already distributed, if the initial premiums paid during a period are not sufficient to meet all the losses and risks incurred during that period. Another distinct feature of *takaful* is that the premiums and reserves can be invested only in *Shariah*-compliant instruments. *Takaful* companies can constitute reserves (like conventional mutual insurance companies), which means that the insured may have to make supplemental contributions if claims exceed premiums. At present, there is very limited application of *takaful* in Islamic financial markets, as very few institutions offer insurance services on a large scale.

Mudarabah **Companies**

The concept of a *mudarabah* company is very similar to that of a close-end fund managed by a specialized professional investment management company. Like a mutual fund, a *mudarabah* company is incorporated as a separate legal entity with a fund management company responsible for its operations. Unlike an Islamic bank, a *mudarabah* company is not permitted to accept deposits; it is funded by equity capital, provided by the sponsor's own subscribed capital and by *mudarabah* investment certificates, which are open to general investors through a public offering. Profits on investments are distributed among subscribers on the basis of their contribution, with the manager of the funds earning a proportion of the profits.

There can be two types of *mudarabah*: multipurpose—that is, a *mudarabah* having more than one investment purpose or objective—and specific purpose. All *mudarabahs*, however, are independent of each other, and none is liable for the liabilities of, or is entitled to benefit from the assets of, any other *mudarabah* contract or *mudarabah* company.

Considering that the *mudarabah* contract is the cornerstone of Islamic finance, *mudarabah* companies can play a critical role in the financial landscape of a developing economy, especially for small- and medium-size enterprises. For them to do so requires a financial sector that inspires investor confidence and facilitates the transparency and operational efficiency of *mudarabah* companies.

NOTES

1. Iqbal and Mirakhor (2007).