

Serving Muslim Clients

A very brief introduction
to Islamic Finance



History of Islamic finance

- Not New – 1500 years of development.
- During Classical period, commerce flourished under Islamic commercial law.
- Development languished and, under the impact of colonialism and huge Western firms became relegated to the souks.
- Revival began in 1960's.
- Increasing rapid growth and sophistication.



Islamic Finance Today

- Islamic finance is rapidly evolving, and has become a widely used and flexible tool in international finance.
- Devout Muslims had been locked out of many individual financial vehicles.
- Pent-up demand, unsuitable situations.
- Many personal alternatives now available.



Religion, Ethics, and Law

- In the West, Religion/Ethics/Legal only loosely overlap.
- *Sharia'a* is the body of Islamic principles with respect to life's activities.
- Islamic *Sharia'a* encompasses both religion and ethics more closely.
- In some countries, *Sharia'a* is also the legal standard.



Religious/Ethical/Legal

Sharia'a is derived from three sources:

- *Quran*, revelations from God.
- *Sunnah*, authenticated sayings and actions of the Prophet (Peace be upon him).

(Individual saying are referred to as *hadith*)

- *Fiqh*, collection of interpretations / rulings / precepts based on the *Quran* and *Sunnah*.



Religious Oversight

- Oversight begins with the *Sharia*'a board for the project / product.
 - A committee of Muslim Scholars.
 - Works with parties to ensure that an undertaking is Islamically acceptable.
 - Issues a *fatwa*, a ruling as to whether a particular undertaking is *halal* (acceptable) or *haram* (unacceptable).
 - A Sharia Board provides continuing oversight.



Religious Oversight

- Conflicting *fatawa*:
 - There may be different schools of thought, sometimes resulting in inconsistent *fatawa*.
 - There is no Central Authority, no “Supreme Court.”
 - In the nature of a majority opinion.
 - A *fatwa* is not automatically accepted, it must stand the test of time and the scrutiny of the body of scholars



Religious Oversight

- Agreement far outweighs disagreement.
- Nonetheless, there are some uncertainties and regional differences in what is considered acceptable.
- For example, Malaysia and Indonesia tend to be more liberal than the Gulf region.
- There are sometimes accusations of “Sharia shopping” for scholars with a favorable view.



Concept of *Riba*

- Probably best known and greatest practical difference from Western finance.
- Widely misunderstood: *Riba* is the prohibition of interest on money.
- Underlying concept: money itself has no intrinsic value.
- Risk sharing is important.
- Since money has no intrinsic value, there should be no charge (interest) for its use.



Concept of *Riba*

- IMPORTANT! *Riba* is interest on money only!!
 - Interest may be constructive – “Hidden *riba*.”
- *Riba* does not preclude a rate of return on investment.
- Islamic finance is sometimes said to be asset-based instead of currency based.
- I.e., an investment is structured on ownership / exchange of assets, money is just the payment mechanism.



Concept of *Riba*

- An Example is a home mortgage:
 - Western: Bank gives you money. You buy the house. You pay interest on the money.
 - Islamic: a *musharakah* arrangement. You and the bank buy the house together in partnership. You make payments that are partly rent and partly buyout of the bank.
 - Islamic: a *murabaha* arrangement. The bank buys the house and sells it to you on a deferred payment schedule.



Concept of *Riba*

- Islamic: an *ijara* arrangement – The bank buys the house and leases it to you on a redeemable lease.
- Note that the payments might be the same for all four alternatives, and the rate of return to the bank might be exactly the same!
- BUT: in the Islamic transactions the rate of return is based on an asset transaction, NOT based on interest on money loaned.



Concept of *Riba*

- Note that in each of these approaches:
 - Money is not exchanged / lent.
 - The exchange is based on an asset.
 - There is a sharing of risk (important).
- Prohibitions against *riba* are extremely strong:
 - Compared to “marrying your mother.”
 - References to the “eternal flames.”
- Christianity and Judaism similar prohibition



Is it just “playing with words?”

- To the Western thought process, the nearly identical financial impact says yes.
- To Muslims, definitely not the same.
- A case close to home:
 - Daughter A marries, has several children.
 - Daughter B runs off “without benefit of clergy,” has several children.
 - The result is the same: grandkids and your daughter lives with a man. Do you see a difference?



Is it just “playing with words?”

- Prohibition of “hidden *riba*.”
- Emphasis is not on “getting around” Islamic precepts.
- Emphasis is on finding mutually acceptable and Islamically compatible solutions to mutual business needs.
- An overarching concept is that the purpose of *Sharia’a* is not to set forth religious prohibitions.



Is it just “playing with words?”

- Instead, the purpose of *Sharia’a* is to assist in removing obstacles to a happier life and reducing discord.
- The unacceptability of *riba* is not just because money has no intrinsic value. Rather, it is intended to avoid injustice and civil discord caused by one party (the lender) becoming unfairly enriched at the expense of another party (the borrower).



Concept of *Gharar*

- Defined as “Preventable or excessive ambiguity or uncertainty.”
- E.G., Western derivatives not permitted.
- Subject of a contract must exist, must be specifiable and measureable.
- Extends to the fairness and validity of a contract.
- Similar to our consumer protection laws.



Forbidden Activities

- Activities that are considered harmful to society:
 - Alcohol.
 - Pork production.
 - Illegal / intoxicating drugs.
 - Gambling.
 - Pornography.
 - Arms production.



Flexibility of Islamic finance

- It is not dogmatic rule-making.
- Attitude is: “How can we make this happen?”, “Lets do business.”
- Exceptions are permitted (but not encouraged) when no alternatives exist.
 - Example: Investing in the common stock of leveraged firms is permitted, but the amount of leverage permitted is limited and that portion of investor return must be “purified.”



The Islamic Market

- 20 to 40% of the world population.
- Not just “furriners” – domestically (USA), estimated between 6 million and 8 million people.
- 2.3 million households.
- Rapid growth – 6% annual.
- Young, highly educated, professional.
- Affluent - above average income.



Islamic Financial Services

- We have seen that:
 - “mortgages” can be Islamically acceptable.
 - Leases can be Islamically acceptable.
 - Investing in common stock can be Islamically acceptable.
- Are Islamic Financial Services available?
- What about stocks, bonds, and Insurance?
- What are my Fiduciary Duties?



Islamic Banking and Mortgages

- Well developed in Britain.
- Available in the U. S., but not as well developed.
- Mortgages have the blessing and Encouragement of the U. S. Treasury.
- A list of Institutions is attached





Equity Investing

- Acceptable if the firm does not engage in prohibited practices mentioned above.
- Some leeway is possible – previous mention of the use of debt.
- Dow Jones Islamic Indexes.
- Listing of firms providing Islamic investments attached.
- Sharia Capital monitors for *halal* firms.



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Islamic Market Indexes

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Overview

The Dow Jones Islamic Market Indexes were created for people who wish to invest according to Islamic investment guidelines. The indexes track Shari'ah compliant stocks from around the world, providing Islamic investors with comprehensive tools based on a truly global investing perspective. [more](#)

<http://www.djindexes.com/mdsidx/index.cfm?event=showIslamic>

NEW: Dow Jones Islamic Market Turkey Index

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Sukuk – Islamic “Bonds”

- Conventional bonds are *riba*, and are forbidden since they are interest based.
- But, again, a transaction structured on an asset base is permitted.
- Fixed income type instruments can be created by the *Murabaha*, *Musharakah*, *Ijara* mentioned above (+ others).
- This type of arrangement is referred to as *Sukuk*, sometimes called “Islamic bonds.”





Noriba Sukuk

<http://www.noriba.com/sukuk.htm>

[Sukuk](#)

Noriba's clients choice, flexibility and diversification in their investment strategy.

The issuance of international Sukuk is one of the most significant mechanisms for raising finance in the international capital markets through Islamically acceptable structures.

Multinational corporations, sovereign bodies, state corporations and financial institutions use international Sukuk issuance as an alternative to a syndicated financing. Sukuk

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are needed to see this picture.

<http://www.euromoneybooks.com/default.asp?page=4&productID=3099>



Takaful - Islamic Insurance

- Principle of *gharar*, or avoidance of risk / uncertainty / gambling.
- Standard western insurance contracts are considered gambling.
- Also, standard Insurance contracts often have interest component.
- It is quite acceptable, however, to form a mutual group for self-help and risk avoidance.



Takaful - Islamic Insurance

- Stock Insurance companies are not acceptable because of the profit motive.
- Resolution of the problem is that the mutual form of insurance can be made Islamically acceptable.
- Referred to as “Takaful.” Rapid growth.



<http://www.takaful-malaysia.com/> (Malaysia)

Main Menu

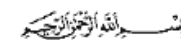
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Syarikat Takaful

Takaful Keluarga

Takaful Umum

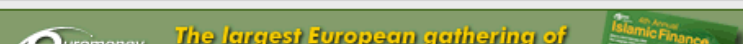


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<http://www.imanlinc.com/> (U.S.A)

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Upcoming Events

for month detail [Click Here](#)

Market Updates

Dow Jones Industrial Avg.

5/15/2003 ET © BigCharts.com

Jurnal & Artikel

Takaful News

<http://www.takaful.com/> (Indonesia)

Funds

- Many Shariah-compatible funds available.
- Equity funds investing in firms that avoid the forbidden activities, *riba*, and *gharar*.
- “Fixed Income” funds that invest in *Sukuk* or similar instruments.
- Hedge funds.
- Similar to religiously oriented funds for Christian investors



Your Fiduciary Duty

- A problem here is that not all Muslims are strict observers.
- IPS must specify “level of devoutness”
- Often heard:
 - 30% don’t care about Shariah!
 - 40% prefer Shariah *if* the return is equal.
 - 30% are strict Shariah.



Your Fiduciary Duty

- You must have at least a basic knowledge of *Sharia'a*
- Must understand:
 - The concepts of *riba* and *gharar*.
 - The role of the oversight board and the meaning of a *fatwa*.
 - The basic types of islamic contracts: ijara, murabaha, mudarabah, musharakah (and others if necessary).



Your Fiduciary Duty

- For any possible portfolio asset, you would need to be sure that:
 - There is an Oversight Board and a Fatwa indicating that the addition is *halal*.
 - OR that the addition is not *haram* – i.e.,
 - There is no *riba* (or the *riba* present is below the acceptable amount).
 - The addition does involve the forbidden activities.
 - There is not excessive avoidable uncertainty (*gharar*)



Your Fiduciary Duty

- Educating your client:
 - Surprisingly, we not only find that many Muslims are not concerned about Shariah when it comes to Finance.
 - But, in addition, many Muslims have little knowledge about Shariah requirements in Finance.
 - Like many of your clients, Muslims may have little understanding of what is available.



Your Fiduciary duty

- Even where Muslim clients may have some understanding of Western finance, they may have no idea that Shariah compatible alternatives are available.



Your Fiduciary Duty

- Sounds more complicated than it is.
- Comparable to serving a client who seeks Christian investments.
- Can a Baptist serve an Episcopalian?
- Existence of *Sharia*'a compatible funds removes much of the requirement – your added fiduciary duty would be establishing the validity of the “*Sharia*'a compatible” claim.



Your Fiduciary Duty

- If you go beyond funds to individual vehicles, fiduciary duty goes up sharply.
- Deals can become quite complicated!
- Risk analysis is often more difficult, especially when dealing across borders with often different legal standards and/or rulings.



Is it just for Muslims?

- Islamic finance is not just for Muslims!
- Many Islamic issues are held by non - Muslim investors.
- Non-Muslims often offer Shariah compatible instruments to tap into a pool of cash that is looking for opportunities.
- Shariah compatible investment opportunities should be considered as simply another class of assets.



Conclusions

- Muslims offer an attractive, and underserved, client pool.
- Serving this client pool requires training in understanding new assets and procedures.
- The fiduciary duty is complicated by a different set of rules and asset types, and requires extra care that the religious requirements are fulfilled.



Conclusions

- Despite the complications, *halal* instruments such as mortgages, both equity and fixed income instruments and funds, insurance, leases and other products are available.
- Many of these investment possibilities may be attractive to your non-muslim clients
- Shariah compatible investments can / should be considered another set of opportunities.

