SECTION 4: INTRODUCTION TO ISLAMIC FINANCE

Islamic finance is the financial services industry which offers finance compliant with Shari'a, the underlying principles and codes of conduct of the religion of Islam.

Islamic finance has commonly been recognised as an interest-free financing system, or a form of ethical finance. Such association has emerged from two perspectives. Firstly the interpretation of the prohibition on Riba, essentially a prohibition on an unjust increment or increase. Interest charged for loan repayments is commonly associated with Riba. In addition to Riba, Shari'a also prohibits Gharar and Maisir which should also be excluded from Islamic financial transactions.

Secondly, the analogy with 'ethical finance' and Islamic finance is often drawn based on the restrictions on engaging in transactions which are 'Haram' – i.e., contrary to the underlying principles in Islam – such as avoiding investments in tobacco and the weapons industry. This 'ethical' feature of Islamic finance often attracts non-Muslims to Islamic finance.

However, there is much more to Islamic finance than these broad analogies. The underlying principles of Islamic finance involve equity, fairness, justice, and social responsibility and morality. (See Figure 1 below).

To understand the essence of Islamic finance, the subject should be understood from its root and in its entirety as opposed to isolated concepts.

History of Islam

While part of the Abrahamic tree of monotheistic religions tracing its roots to Adam and Eve, the religion of Islam as we know it today began when the Word of God was revealed to the Prophet Mohammed (PBUH). The word Islam means peace and has also been interpreted as meaning 'submission', or the total surrender of oneself to God. The followers of Islam are known as a Muslims, meaning 'one who submits (to God)'. Muslims believe that God revealed the Qur'an to Prophet Mohammad (PBUH), God's final prophet, and regard the Qur'an, Sunnah and Hadith (the words and deeds of Prophet Muhammad (PBUH)) as the primary source of Shari'a, supported by secondary sources such as Ijma, Qiya's and subject to jurisdictional application, Ijtihad.

Islam includes many religious practices. Followers are generally required to observe the Five Pillars of Islam, five duties that unite Muslims into a community.

The Qur'an is recognised by Muslims as the unequivocal word of God and the Qur'an is better described as prescribing a code of conduct or a way of life for Muslims. Islam prescribes codes of conduct for everyday life, commercial interactions, and underlying principles of behaviour, conduct and dealings in certain products which are acceptable – ie, denoted as Halal. Prohibited behaviour and dealings are denoted as Haram. These codes, principles, and classification of Halal and Haram are collectively referred to as Shari'a. Within Shari'a, there are principles which apply to dealings in commerce and business known as 'fiqh al muamalat'. It is from these principles that Islamic finance emerged in the 1970s with the establishment of the world's first commercial Islamic bank.

Principles of Islamic finance

These principles are derived from the Qur'an, Sunnah and Hadith (and supporting Ijma and Qiya's (as well as Ijtihad in certain markets)) which are approximately a thousand years old. These principles underpin the Islamic finance industry, and their application in modern day finance requires persons appropriately skilled in both Islamic jurisprudence ('fiqh') and finance to interpret and apply them to financial structures to ensure that they accurately conform with Shari'a compliance. Such persons are referred to as Shari'a scholars and their role is key to the current and future direction of Islamic Finance. (Illustrated in Figure 1).

Figure 1: Principles and Prohibitions in Islamic Finance.

1. Principles of Profit and Loss Sharing.	Islamic Finance requires participation in and sharing of profit and potential losses in financial enterprise.
2. Prohibition on Riba.	Riba is translated as an 'excess' or 'unjust increment' and is classified in two forms: 1. Riba Al Fadl- which is described as excess compensation or an unequal exchange or sale of goods, usually relating to the exchange or sale of specified commodities including gold, silver, barley, wheat, salt and dates. Historically these commodities were treated as money and therefore the exchange of these commodities had to be in equal amounts. Any excess in the exchange of one or more of the

	commodities would be unfair to one party and was and is prohibited. 2. Riba Al Nasiah- is described as any excess over the principal amount paid which is charged for the delay in repayment. It is Riba Al Nasiah which is associated with the prohibition on interest.
3. Avoidance of speculation (Maisr) and uncertainty (Gharar).	Transactions have to be real and be certain and not based on uncertainty or speculation. Islamic Finance is essentially about real trans actions which are based on identifiable assets and transparent contractual terms. Derivatives are often prohibited where the transaction is purely speculative.
4. Prohibition on dealing in items which are Haram and the requirement to deal only in Halal items.	All dealings, commercial or otherwise in prohibited items, i.e. those denoted as 'haram' are strictly prohibited. Prohibited items include: • Riba • Pork • Pornography (as this corrupts morality) • Tobacco and Alcohol (any form of intoxication which impairs the senses removing responsibility is prohibited) • Weapons and arms (Islam is a religion which promotes peace, tolerance and acceptability, unjust wars are prohibited). • Conventional financial services (as conve-ntional financial services may deal in prohib-ited or haram items, such as interest and debt). • Speculation and uncertainty (including casino's).
5. Requirement for fair and transparent dealings.	Islam requires that commercial dealings are fair and transparent to ensure that all par-ties are aware of their respective rights and obligations.

Role of Shari'a scholars in Islamic finance

To ensure that the underlying financing structure is Shari'a-compliant – i.e., conforms with these underlying principles of Islam, the role of Shari'a scholars becomes critical. Shari'a scholars play a pivotal role in applying Islamic jurisprudence to financial transactions, by identifying how the underlying Islamic principles can be applied to ensure that the financing structure meets the required principles of Islam.

Their interpretation and application of the underlying principles of Islam, (collectively referred to as Shari'a) which is issued in the form of a ruling, is referred to as a fatwa.

Shari'a scholars will give a ruling on whether a financing structure meets the requirements of Shari'a to qualify as Shari'a-compliant. In the context of Islamic Finance, the fatwa's issued by Shari'a scholars are applied to financial transactions by financial institutions to ensure that the products and financing structures are Shari'a-compliant.

Put simplistically in order to provide an analogy, the Shari'a interpretation and oversight function of Shari'a scholars is in some respects similar to that of judges in common law systems, where judges interpret and apply doctrines prescribed by statutes, laws and precedents which evolve to reflect the market.

In the context of Islamic finance, Shari'a scholars interpret and apply Shari'a. In both common law and Islamic jurisprudence, case law and fatwa evolve to reflect the current environment. It is worth noting however that fatwa are essentially opinion's issued by qualified Shari'a scholars, and as such fatwa's do not necessarily have legal force and it is possible for scholars to have a different opinion.

In respect of the interpretation and application of Shari'a, there are five perspectives, four of which are predominant perspectives, or put another way, there are differences in how Shari'a is interpreted. These are referred to as Schools of Thought – i.e., religious perspectives, and the interpretation and application of Shari'a may vary across these Schools of Thought. Certain jurisdictions have a predominant School of Thought, and hence a particular perspective on the interpretation of Shari'a. Such differences often lead to different interpretations and accepted and prohibited modes of Shari'a-compliant finance across the Schools of Thought and across jurisdictions.

Within jurisdictions a 3 member Shari'a Supervisory Board is common practice across the Middle East to ensure that there is a majority consensus amongst the Scholars when issuing fatwa's.

Even with the differences in Shari'a opinions and the common analogies with conventional products, there is clearly an objective and legitimate purpose that Islamic finance is fulfilling which is not being met by the conventional markets. How the Islamic financial services industry evolves from this point forward will influence the perception and credibility of Islamic finance.

Future of Islamic finance – the principle of Tayyab

The underlying principles discussed earlier have formed the basis of Islamic finance since its inception 35 years ago. There are other concepts and principles established in the Qu'ran which are applicable to Islamic finance and which can facilitate greater Shari'a compatibility of finance transactions. The industry stands at a very important junction in terms of its development, success and credibility for the future. The industry, although a key component in the global financial system, must ensure that it can justify its legitimacy as an industry. Such legitimacy is to be found in ensuring that the underlying spirit of Shari'a is complied with as the industry faces pressure to innovate new Shari'a-compliant financial products.

Complying with the letter and spirit of Shari'a provide greater opportunities to promote greater Shari'a-compliance than has been the case in respect of some of the current Islamic financing structures. In essence, Islamic finance is an equity-based, not a debt-based system. Some practitioners, such as RHT Partners in Dubai are pioneering the future direction of Islamic Finance to encourage adherence to both the letter and spirit of Shari'a by taking a holistic view on Shari'a- compliant finance by applying the additional principle of Tayyab.

Tayyab is the underlying principle associated with consumption of that which is 'wholesome and more beneficial', not just 'compliant'. In the context of Islamic finance, Tayyab ensures that Islamic financial products are developed with a focus on holistic, equitable Islamic criteria of transparency, accountability, and fairness to ensure the credibility of the Islamic finance industry as a whole is maintained.

The future of Islamic finance depends on ensuring compliance with the underlying principles and purposes of Shari'a, not just the letter of Shari'a but the spirit too.

The DIFC provides a forum for such innovation and development in the field of Islamic Finance. The Shari'a system's regulatory infrastructure provides the necessary degree of flexibility to encourage greater innovation in Islamic finance. In the absence of a centralized Shari'a Board, the appointment of a three-member Shari'a Supervisory Board ensures that the products comply with both the letter and spirit of Shari'a.

This guide summarises the regulatory obligations which apply to firms which seek to be licensed to offer Islamic finance in or from the DIFC by setting out the operating environment in the DIFC (See Figure 2). Section 6 of this guide summarises the products and instruments, specifically capital market instruments which can be offered from the DIFC by both DFSA Authorised Firms as well as non authorised entities.

Figure 2: Summary of Islamic Finance in or from the DIFC in the context of the DIFC Law Regulating Islamic Financial Business

1. The Service
Provision of Financial Services/ offer of Financial Products

2. Characteristics
In compliance with Shari'a or the principles of the religion of Islam

3. Description of Shari'a
Shari'a is a collective term for principles which guide the daily conduct of Muslims. There are a number of sources of Shari'a

4. Sources of Shari'a
Quran, Sunnah, Hadith, Ijma, Ijtihad, Qiya's

5. The Established Principles
The Principles of Shari'a as derived from the Qu'ran, Sunnah and Hadith, are subject to Islamic jurispru-dence and interpretation and adaptation

6. Underlying Principles 'Shari'a'
i)Prohibitions:
- Riba
- Pork
- Pornography and Entertainment industry
- Alcohol & Tobacco
- Arms and weaponry
- Conventional financial services;
- Speculation and uncertainty
- Gambling and Casino's

ii) Principles of Profit & Loss sharing, no unjust enrichment, equity & fairness