# FACT SHEET

## Overview of Islamic finance

### 1. Background

1.1 Islamic finance refers to the financial activities that are consistent with the principles of Islamic law, known as Shariah. Shariah is based on the text of Quran (considered by Muslims as the revealed word of God) and the Sunnah (the sayings and practices of Prophet Muhammad).

1.2 Islamic finance has expanded rapidly in recent years, as evidenced by the growth in Shariah-compliant financial assets worldwide by over 10% per annum during the past decade[1]. At present, Islamic finance represents a small growing segment of the global finance industry. Measured by Shariah-compliant assets held by financial institutions, the global Islamic finance industry was estimated at US$822 billion (HK$6.4 trillion[2]) in 2009[3, 4]. This figure is projected to reach US$1 trillion (HK$7.8 trillion) in 2010 and US$1.6 trillion (HK$12.4 trillion) by 2012[5].

1.3 The purpose of this fact sheet is to provide the Panel on Financial Affairs with background information on Islamic finance in terms of its underlying principles, financial instruments, global development and regulatory environment.

### 2. Key principles underlying Islamic finance

2.1 Shariah provides guidance or principal rules governing all aspects of the day-to-day activities of Muslims, including religion, politics, finance, business and family. Major principles of Shariah that are applicable to Islamic finance are outlined in paragraphs 2.2-2.7.

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1 See Standard & Poor's (2009).
2 Based on the average exchange rate of HK$7.752 per US Dollar in 2009.
3 See The Banker (2009).
4 For comparison, the aggregate assets of the top 1 000 banks in the world amounted to US$90 trillion (HK$698 trillion) in 2008. See HSBC Amanah (2010).
5 See Australia Trade Commission (2010).

Prohibition of riba (interest)

2.2 The prohibition of payment and receipt of interest income (riba) serves as the first legal and economic foundation of Islamic finance. Making money from money is not acceptable under Shariah. Money itself is considered to have no intrinsic value, merely serving as a medium of exchange and a store of value. As such, putting money in a bank or lending money to someone else in order to earn riba is not allowed.

Prohibition of gharar (unacceptable uncertainty/risk) and maisir (gambling)

2.3 Gharar refers to unacceptable uncertainty or risk caused by a lack of clarity regarding the subject matter or terms in a contract or exchange. A sale or any other business contract entailing an element of gharar is prohibited. Such prohibited activities include any transaction of probable items whose existence or characteristics are not certain at the time of contract, due to the lack of information, ignorance of essential elements in the transaction to either party, or uncertainty of the ability of one party to honour the contract. In Islamic finance, the prohibition of gharar is the basis for disallowing financial products/practices such as short selling, speculation, insurance[6] and derivatives.

2.4 Maisir, translated as gambling, is prohibited under Shariah. Conventional financial products such as derivatives and insurance[7] and speculation practices are considered to embody an element of maisir and as such are forbidden in Islamic finance.

Profit and loss sharing

2.5 Parties involved in a financial transaction must share both the associated risks and profits. Earnings of profits or returns from assets are permitted as long as the business risks are shared by both the investor and investee concerned.

6 According to Shariah, the insured-insurer relationship involves the trading of gharar (uncertainty), as the insured pays premium to the insurer for an object (i.e. the monetary compensation in case of an accident) that he or she may never receive (i.e. the accident never takes place).

7 Maisir exists in an insurance contract as the insured may either lose all the premiums when the insured event does not occur, or be compensated for the losses he or she incurs for the insured event.

Asset-backing

2.6 Each financial transaction must be underpinned by an identifiable and tangible underlying asset. For example, asset-based lending is allowed under Shariah while paper-based lending is not.

Ethical investment

2.7 Investment in businesses dealing with alcohol, gambling, pork-related products, drugs, pornography or anything else that Shariah considers unlawful is prohibited.

## 3. Islamic financial instruments

3.1 There are a variety of financial instruments that are acceptable from a Shariah point of view. In practice, financial transactions can involve a combination of these instruments and Shariah-compliant firms often structure financial products using a mix of them to suit customer requirements. Some of the most common financial instruments used for Islamic financing are summarized below.

Murabaha (cost-plus financing)

3.2 Murabaha is a form of asset financing where an Islamic bank purchases a tangible asset at the request of its client and resells it to the client with a mark-up. The client pays for the asset in deferred payments or over a stated instalment period. The interest that would ordinarily be paid by the client in a conventional loan is replaced by the difference between the purchase price and the sale price. Murabaha financing is most often used for financing trade and home purchases[8].

[8] Under Murabaha finance, a home buyer finds a house he or she wants can approach an Islamic bank and request it to purchase the house for him or her. The home buyer will at the same time give an undertaking to buy the house back from the bank at a higher price. If agreed, the bank will purchase the house and resell it to the home buyer with a mark-up against periodic payments.

Mudaraba (partnership financing)

3.3 Mudaraba is a form of partnership where one party provides the capital while the other provides its expertise to invest the capital and manage the associated investment project. Profits so generated are shared between the partners according to a pre-determined ratio, whereas losses accrued are borne by the capital provider only. Mudaraba is often used for investment funds with investors providing money to an Islamic bank, which manages and invests the money in a Shariah-compliant project or portfolio in return for a share of the profits.

Musharaka (equity sharing)

3.4 Unlike a Mudaraba transaction, both partners in Musharaka must contribute capital to the partnership. Both partners or one of them may manage the joint venture or alternatively both may appoint a third party to manage the investment. While profits are shared in a pre-determined ratio, losses are shared in proportion to the capital contributed. A variant form of Musharaka is diminishing partnership commonly employed for home financing[9].

Ijara (leasing)

3.5 Ijara is a leasing contract, where the bank buys and leases out the asset required by the client for a rental fee. Ownership of the asset remains with the lessor bank, which will seek to recover the capital cost of the asset plus a profit margin out of the rental payable. The leasing contract may include an option for the lessee to buy the asset at the end of the lease, similar to the conventional hire-purchase contract.

Sukuk (investment certificates)

3.6 Sukuk are investment certificates economically equivalent to bonds. Unlike bonds, which are debt-based instruments that pay interest, Sukuk are asset-backed or asset-based instruments and represent the ownership by the Sukuk holders in the underlying pool of tangible assets. Sukuk holders are entitled to a share in the revenues generated and the capital appreciation of the assets involved. Sukuk can be issued by governments or private companies.

9 Under diminishing Musharaka, the financier and the customer enter into a partnership to co-own a property. They agree at the start that their respective shares in the property shall be pro-rata, based on their contributions towards the purchase price paid to the vendor. The customer will purchase the share of the financier by periodic regular payments until he or she becomes the sole owner of the property.

Takaful (insurance)

3.7 Takaful is a Shariah-compliant cooperative insurance arrangement where a group of individuals agree to share the risk of a potential loss to any of them[10]. Each individual fulfils his or her obligation by contributing a specific sum of money (known as Tabarru) to a fund[11], and the pooled capital will be used to cover payouts to member of the group when a claim is made.

3.8 In Takaful, participating members are acting both as insurers and insured as they are mutually contributing to and potentially benefiting from the fund. The Takaful fund is managed by a third party (the Takaful operator), who will invest only in Shariah-compliant assets. In return, the Takaful operator will receive a fee for the services provided to the fund. At the end of a financial year, the profits (net of expenses and claims payable) earned by the Takaful fund will be shared among its members, thereby instilling an element of profit sharing into the cooperative insurance scheme.

## 4. Global development of Islamic finance

4.1 Modern Islamic finance emerged in 1963 when Egypt experimented with the setting up of a savings bank operating under the Islamic interest-free and profit and loss sharing principles. This was followed in 1975 by the establishment of both the Islamic Development Bank and the Dubai Islamic Bank, which were committed to conducting banking operations in full conformity with the Shariah principles. Since then, Islamic banking and finance has spread to a large number of Muslim countries, including the Gulf Co-operation Council states[12] and Malaysia.

4.2 Islamic finance grew through the late 1970s with traditional retail and commercial banking activities (including trade financing) gradually being re-cast in Shariah-compliant forms. Since then, Islamic financial products have grown in range and sophistication to include insurance, capital market and fund management products (See the **Appendix** for the evolution of Islamic financial products).

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[10] Conventional insurance is unlawful under Shariah because it contains the elements of gharar and maisir. In addition, certain types of investments offered by conventional insurers are not permissible under Shariah, for example, interest-bearing instruments and investments linked to alcohol or gambling. See Jobst (2007) and Mallesons Stephen Jaques (2009).

[11] Shariah treats the contributions as Tabarru (i.e. donation for the benefits of others) rather than a premium. Making a donation to help other people who suffer loss is considered to be compliant with the Shariah principles. In contrast, paying a premium under conventional insurance for the benefit of obtaining future payments of claims resulting from unforeseen events is considered to be un-Islamic.

[12] The Gulf Co-operation Council states comprise Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

4.3 During the same period, Shariah-compliant financial institutions have also grown in number, with enlargement of their product varieties in parallel. There are currently over 300 Islamic financial institutions worldwide, comprising commercial banks, investment banks, Islamic windows[13], insurance companies, fund management companies and other financial services companies.

4.4 In recent years, Islamic finance has extended from its original strongholds in the Middle East and Malaysia to other parts of the world. In particular, it has spread to international financial centres such as New York, London, Tokyo, Singapore and Hong Kong[14], and established its presence in more than 75 Muslim and non-Muslim dominated countries. At end-2008, Iran was the largest market for Islamic finance, accounting for 35.6% of Shariah-compliant financial assets worldwide. It was followed by Saudi Arabia (15.6%), Malaysia (10.5%), the United Arab Emirates (10.2%), Kuwait (8.3%), Bahrain (5.6%), Qatar (3.4%), the United Kingdom (2.3%) and Turkey (2.2%)[15].

## 5. Islamic finance regulation

5.1 A financial institution involved in Islamic finance will normally establish an internal Shariah supervisory board, which consists of Shariah scholars to determine whether its financial activities are Shariah-compliant or not. In particular, the board will review the institution's product and service structures, and evidence its opinion on their compliance by issuing a "fatwa". "Fatwas" are written legal opinions issued by Shariah scholars to endorse the launch of Shariah-compliant financial products or services in the market.

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13 Islamic window is a term used for describing conventional banking institutions that offer Shariah-compliant products through their main distribution networks, e.g. branches providing both conventional and Islamic banking and financial products. Islamic windows do not hold an independent banking licence and are under the sponsorship of the parent bank.

14 Similar to Singapore, Hong Kong is a relatively new entrant into the Islamic financial market. In his 2007-2008 Policy Address, the Chief Executive of the Hong Kong Special Administrative Region identified the development of an Islamic bond market in Hong Kong as a key government initiative. Some of the recent developments in the local Islamic banking and financial industry included (a) the introduction of Islamic mutual funds in late 2007, (b) the listing of a US$550 million (HK$4.3 billion) Sukuk on the Hong Kong Stock Exchange in March 2008, (c) the launch of an Islamic equity index (featuring Mainland companies listed in Hong Kong) in May 2008, and (d) the opening of the first Islamic banking window by a Malaysian bank in August 2008. See Australia Trade Commission (2010) and Hong Kong Monetary Authority (2008).

15 See International Financial Services London (2010).

5.2 Since Shariah scholars belong to various Islamic schools of thought, they may interpret Islamic law in varying ways. On a practical level, this means that for Islamic finance, certain contractual terms considered to be permissible under Shariah by some scholars may be deemed unacceptable to others. As a result, there can be different opinions, either within or across national borders, on the permissibility of certain financial instruments. There have been initiatives to standardize Shariah-compliant financing regulations with the objective of enhancing the marketability and acceptance of Islamic financial products.

5.3 A number of international institutions have been established to promote international consistency in Islamic finance. For example, the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) was established in 1990 to issue accounting and auditing standards and corporate governance norms for the Islamic finance sector. As an independent international organization, AAOIFI is based in Bahrain and supported by institutional members (200 members from 45 countries) including central banks, Islamic financial institutions and other participants in the international Islamic banking and finance industry.

5.4 In addition, the Islamic Financial Services Board (IFSB), based in Malaysia, was established in 2002 to promote the integration of the Islamic finance industry into the global financial system by issuing prudent standards for Islamic finance to complement existing international standards for the conventional finance industry[16]. As of November 2009, there were 193 members of IFSB – 49 regulatory and supervisory bodies, six international inter-governmental organizations (including the World Bank, the International Monetary Fund, the Bank for International Settlements and the Asian Development Bank) and 138 industry stakeholders.

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[16] Islamic financial institutions, like conventional financial institutions, are regulated by national authorities which are aligned with international standard-setting bodies such as the Bank for International Settlements. The Bank for International Settlements is an international organization of central banks which formulates broad supervisory standards and guidelines, and recommends statements of best practices in banking supervision.

## Appendix

### Evolution of Islamic financial products

| **Evolution** | **1970s** | **1980s** | **1990s** | **2000s** |
|---|---|---|---|---|
| **Area** | • Gulf/Middle East | • Gulf/Middle East<br>• Asia Pacific | • Gulf/Middle East<br>• Asia Pacific | • Gulf/Middle East<br>• Asia Pacific<br>• Europe/Americas |
| **Institutions** | • Commercial Islamic banks | • Commercial Islamic banks<br>• Takaful<br>• Islamic investment companies | • Commercial Islamic banks<br>• Takaful<br>• Islamic investment companies<br>• Asset management companies<br>• Brokers/Dealers | • Commercial Islamic banks<br>• Takaful<br>• Islamic investment companies<br>• Asset management companies<br>• Brokers/Dealers<br>• Islamic investment banks<br>• E-Commerce |
| **Products** | • Commercial banking products | • Domestic Islamic bonds<br>• Takaful products<br>• Commercial banking products | • Mutual funds/unit trusts<br>• Domestic Islamic bonds<br>• Shariah-compliant stocks<br>• Islamic stock broking<br>• Islamic derivatives<br>• Takaful products<br>• Commercial banking products | • Global Islamic bonds<br>• Islamic asset-backed securities<br>• Mutual funds/unit trusts<br>• Hedge funds<br>• Private Equity & Islamic REITs<br>• Domestic Islamic bonds<br>• Shariah-compliant stocks<br>• Islamic stock broking<br>• Islamic derivatives<br>• Takaful products<br>• Commercial banking products |

Source: CIMB Islamic (2008).

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