Islamic Contributions to Economics and Finance: given the present global economics situation

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• Conventional Banking System.
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Aims of Presentation

- To investigate the likelihood of the financial crisis if the Islamic financial system had been globally adapted.

- To include a brief description of the main causes of the global financial crisis mentioned by experts, mainly the subprime and adjustable rate mortgages (ARM).

- To include Islam’s position on interest, which prohibits it.

Aims (Cont...)

- To discuss the basic contract used by Islamic Banks, such as, *mudarabah* and *murabaha*, are described.

- To make a comparison between the Islamic and conventional financial systems.

- This research claims that the Islamic system could have prevented the crisis.
Since the year 2007, the media has discussed the possibility of a “world financial crisis”.

Several economists have written about problems in the current financial system and in conventional banks’ transactions that may lead to a financial crisis.

The financial crisis did occur when it became crystal clear that the global economy was in trouble. At that point, economists, even non-Muslims, became more interested in the Islamic Financial System (IFS) and Shari’a compliant transactions.

Based on the concept of loaning on a fixed rate of interest.

Check on financial background before lending to ensure repayment.

The longer the borrower takes to pay; the more he will have to pay.

One type of loans is Adjustable Rate Mortgages (ARM) that allow banks to increase the interest rate during payment.

Another type of loan is “sub-prime”, which is a loan given to people who do not meet the prime requirements for a loan.

Banks also resell loans to other parties to acquire more cash to lend. The borrower will payback to the new owner of the loan.
Global Financial Crisis

- Bush’s administration made financial companies increase sub-prime loaning to citizens who wanted to buy houses.
- As a result, the sub-prime mortgages increased by 292% from 2003 to 2007.
- More people borrowed and bought houses.
- Consequently, housing prices increased and a housing bubble formed.
- After a while, several borrowers failed to meet payment, and their houses were foreclosed.
- The banks ended up having too many foreclosures, and housing prices collapsed.

Global Financial Crisis (Cont...)

- Banks and financial companies suffered decrease in their assets and stock prices.
- Some banks and companies declared bankruptcy.
- Some banks increased the requirement for loaning so that it became very difficult to acquire a loan.
- Liquidity decreased in the market, and the US economy entered a phase of recession.
- Since international companies worked in the US and specifically in paying loans, they got affected and the crisis extended to world markets.
Islam and Interest

- Allah Almighty said: “Trading is only like usury, *riba*” whereas Allah has permitted trading and forbidden usury *riba* [Qura’an, 2, 275].
- The verse shows clearly that Allah has forbidden usury (*riba*). Is *riba* and interest the same thing?
- Two views:
  - Modernists say that *riba* and interest are different.
  - Neo-revivalists say *riba* is exactly the same as interest.
  - According to various scholars, the neo-revivalist view is stronger and more consistent.

Islam and Interest (Cont...)

- *Riba* is “The amount that a lender receives from a borrower at a fixed rate of interest”.
- According to scholars, interest-based systems increase the damage and risk that a business is subjected to compared to the Islamic system.
  - In a conventional system, even if the borrower’s business fails, he will still have to pay the loan.
  - In the Islamic system, no loans but investments are used. Hence, if a business fails, one can start again.
- The Islamic finance system allows people to start from zero rather than below zero, as the interest-based system.
- Interest is considered by Islam to be a means to exploit the needs of the poor.
Islamic Finance System

- Islamic finance fulfills all its requirements based on the principles of Shari'a.
- The system of Islamic finance is firmly embedded in both the Qur'an and teachings of the Prophet Muhammad (PBUH).
- The first Islamic financial organization, the Mit Ghamar project, was established in Egypt in 1963,
- Islamic banks have flourished since the 1970s when oil prices increased and the Arab Gulf countries became economically active.

Shari’a Complaint Transaction

- Before making use of the Islamic financial system, financial institutions have to avoid any contradiction with the rules of Shari'a businesses like the following:
  - Interest *riba* is used to create new money which is prohibited in Islam as any gained money in business must be through profitable investments.
  - Gambling is a type of business in which the outcomes are not known and are driven by chance.
  - Prohibited investments are the investments in what Shari’a has prohibited like pork, pornography, and alcohol.
  - Uncertainty *Gharar* is a business in which the contract sets forth an uncertain subject matter.
Shari’a Complaint Transaction (Cont…)

 Variety of Islamic transactions:
• Mudarabah;
• Musharakah;
• Murabaha;
• Istisna’a;
• Ijarah;
• Bai’a al-Salam;
• Sukuk;
• Bank Account.

Mudarabah

 Definition:
• A kind of partnership where one partner provides money to the other for investing in a commercial enterprise.

• The investment always comes from the first partner who is known as rabbu-al-mal.

• The other partner who is fully responsible for the management of the business is known as mudarib.

• It is a type of contract that is common under some circumstances where Islamic banks tend to deal with their customers’ investment portfolios.
**Musharakah**

- Definition:
  - A joint enterprise where all the partners share the profit or loss of the joint venture.

- Plays an essential role in an economy based on the principles from Islam.

- A mutual contract must be established between the parties.

- The contract must take place with free consent of the parties without any misrepresentations.

- The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business.

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**Murabaha**

- Definition:
  - A cost-plus-sale contract is a common term from Islamic *Fiqh* that creates a reference to a particular type of sale which has nothing to do with financing.

- Does not have to involve the concept of a deferred payment.

- **Rules to be followed:**
  - the thing subjected for selling must be present at the time of selling.
  - the thing subject for selling must be owned by the seller at the time of selling.
  - the thing subjected for selling must be in the physical or constructive ownership of the seller when he/she sells it to another person.
**Istisnaa’**

- **Definition:**
  - A type of transaction where the seller manufactures a defined product for the buyer at an agreed price.

- **Used on occasions where particular goods are to be produced:**
  - one of the parties buys the goods and the other takes them to manufacture them according to the specifications mentioned in the contract.

- **Rules to be followed:**
  - the manufacturer, who is considered to be the seller, must provide the required material to make the required goods.
  - it should only be subjected to things that involve manufacturing.

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**Ijarah**

- **Definition**
  - *Ijarah* is an Islamic *Fiqh* based term that means “to give something on rent”.

- The first type of *ijarah* is the rent of the services of an individual for an agreed wage given to him by the employee.

- The second type relates to the usufructs of assets and properties and is used in two different situations:
  - The first one is called the operating *ijarah* in which the lessee enjoys the usufruct of the property for an amount of money to the lessor.
  - The second one is called *al-ijarah al-muntahia bi al-ttamlik* that ends with transferring the ownership of the property to the lessee.
**Ijarah (Cont...)**

- **Basic Rules for operating *ijarah***
  - The leased property must be under the ownership of the seller for the contract to be valid.
  - The leased property must be inconsumable.
  - All the liabilities emerging from the ownership of the property have to be covered by the lessor, whereas all the liabilities related to the use of the property have to be covered by the lessee.
  - The lessee has no rights to use the leased asset for any purpose other than the one specified in the lease contract agreed between them.
  - The lessor has the right to ask for compensation from the lessee for any misuse or negligence caused by the lessee to the leased asset.

**Ijarah. (Cont...)**

- It is necessary that the leased property is fully identified by both parties.
- Example for the first type of *ijarah*.
  - The hiring of teachers by the government.
- Example for the operating *ijarah*.
  - The leasing of houses.
- Example for *ijarah al-muntahia bi al-tamlik*.
  - Real estate.
Bai’a Al-Salam

- It is a kind of sale where the buyer paid for the seller in advance at discounted price in exchange for a still to be manufactured good that will be supplied at a future date.
- The reason behind the allowance of this type of transaction by the Holy Prophet Mohammad (PBUOH).
  - To meet the needs of poor farmers.

- Basic conditions for validity of salam.
  - The buyer must pay the price in full to the seller at the time of agreeing the contract.

Bai’Al-Salam (Cont…)

- Salam can be used in the commodities where the quality and quantity of which can be specified exactly.
- The quality of the commodity must be specified explicitly leaving no room for ambiguity.
- The date and the place of delivery must be specified exactly in the contract.
**Sukuk**

- *Sukuk* is distinguished as asset based bonds that are structured on a back-to-back basis.
- *Sukuk* represents balanced beneficial ownership that includes risks/rewards in an asset usually for a distinct period of time.
- There are 14 types of *sukuk* and the famous one is *sukuk al ijarah*.
- *Sukuk* can be converted into stocks.

**Bank Account**

- It is a term used for the funds deposited in a bank that are credited to and subject to withdrawal by the depositor.
- There are three different bank accounts offered by Islamic financial institutions which are current accounts, investment accounts and saving accounts.
- They are different from those offered by conventional banks.
- **Current Accounts**:
  - They are not a source of income for the customer.
  - They must maintain liquidity at 100% at all times.
  - The customer can withdraw money at anytime.
  - The financial institution can use the money for investment at its own risk and can possess any profit made due to this investment.
**Bank Account (Cont...)**

- **Investment Accounts:**
  - The money deposited will be invested according to Shari’a rules.
  - Any profits achieved or losses suffered are to be accounted directly for the customer.
  - The depositor can only withdraw money after giving notice to the bank.
  - The financial institution has the right to charge fees for its services.

- **Saving Accounts:**
  - There is no interest on saving accounts.
  - They benefit from the profits made by the financial institution throughout the year via investing the money deposited.
  - The depositor can only withdraw money after giving a notice to the bank.
Main causes of financial crisis are:
- Adjustable Rate Mortgages (ARM).
- Sub-prime loans.
- Reselling of loans.

Islam prohibits use of loans and interest. It encourages use of investment and partnership. Thus, it would have prevented the crisis.

Islam provides an alternative to the interest system.

Islamic banks are the least affected by the crisis, which proves the success of Islamic finance.

Countries Affected by The Financial Crisis. Islamic Economies are in acceleration not depression.
Conclusion

- Causes of financial crisis are:
  - Adjustable Rate Mortgages (ARM)
  - Sub-prime loans
  - Reselling of loans

- Islam has forbidden interest and encourages the use of investment to facilitate business rather than loans.

- Islam provides an alternative to interest system through Shari’a compliant transactions.

- Islamic financial system would have prevented the crisis if it was globally implemented.

THANK YOU FOR LISTENING

Any Questions?