CHAPTER 1

History and Core Principles of Islamic Finance

An often-raised question is: What actually is Islamic finance and in what way does it differ from conventional finance? Islamic financial services pledge to conduct financial intermediation in accord with a code of behavior based on Islamic values. The code's principles are enshrined in the contracts and product offerings. It happens to use the word *Islamic* to characterize its observance of the code. Possibly for that reason, in the current international context, it gathers champions and advocates, attracting many who see in it merely a business opportunity; it raises open (sometimes vehement) as well as silent opposition; and it often leaves many puzzled about its nature and value added. This leads to unnecessary mystification and often poorly based judgments. Better knowledge of its history, principles that the sector pledges to observe, the industry's compliance with market demand for transparency and truth in advertisement, and finally market developments can promote balanced views and effective dialogue. It can help assess the potential contribution of the sector to development, in a professional way.

HISTORY REVIEW

An important milestone in the development of modern Islamic finance is the establishment of Mit Ghamr local savings bank in Egypt in 1963. Although the bank provided only basic banking services, these met the requirements of the local community it served at that time. This important experience sent a clear signal in Egypt and beyond that *Shari'a*-compliant finance was feasible and relevant, notably to communities seeking alternatives to conventional finance.

Starting in the late 1970s in the wake of the sharp increase in oil prices and the considerable wealth that it channeled to the Middle East and Malaysia, Islamic banks started to spread across Muslim and non-Muslim countries.

More than 100 Islamic banks were opened and operating across the world. The Islamic Development Bank (IsDB) was established in 1975 by Saudi Arabia and other Organization of Islamic Conference (OIC) member countries.

Dubai Islamic Bank was established in 1975; Faisal Islamic Bank, Egypt, was established in 1977; and Bahrain Islamic Bank was established in 1979.

An important development in the 1980s was the transformation of the whole financial system of Iran, Sudan, and in principle Pakistan to accord with Islamic precepts.

Another important development in the 1980s was the establishment of two groups of companies: Dar al-maal al-Islam in 1981 and the Al-Baraka group in 1982. Dar al-maal al-Islam was founded in the Bahamas; it is headquartered in Geneva and operates ten Islamic banks, seven Islamic investment companies, seven trading companies, and three *takaful* (Islamic insurance) companies in 15 countries around the world. The Al-Baraka group was established in Saudi Arabia in 1982 and currently has activities in more than 43 countries. It has over 2,000 companies, including 15 Islamic banks and several Islamic insurance companies.[1] Moreover, perceiving the business opportunity, conventional banks started offering *Shari'a*-compliant products to customers through dedicated channels known as Islamic windows. From 1963 to the present, Islamic finance has gone through different stages, evolving from infant industry to maturity.

However, as in many human endeavors, the industry's development was led by champions who believed in the business model and had the vision of its practicality. Thus, the international development of Islamic finance was spearheaded by country authorities and financial entrepreneurs in Malaysia and the Gulf Cooperation Council (GCC) region.[2]

The authorities in Malaysia adopted a proactive policy to develop Islamic finance, notably in response to the country's Muslim community's aspirations. First, the Lembaga Urusan Tabung Haji (LUTH) was established in 1969 as a *Shari'a*-compliant savings institution to support people going on pilgrimage to Mecca. The first Islamic bank, Bank Islam Malaysia Berhad (BIMB), was established later, in 1983, licensed and regulated by Bank Negara Malaysia (BNM), the country's central bank. Bank Muamalat Malaysia Berhad (BMMB) came later in 1999. Malaysian authorities, in

[1] Saidat A. Otiti, "Evolution of Islamic Banking & Finance," Muslim Public Affairs Center, 2nd series, August 2011, at www.mpac-ng.org/archived-article/636-evolution-of-islamic-banking-a-finance.pdf.

[2] It is relevant to note that according to some estimates, the world Muslim population is expected to reach 2.2 billion by 2030, an increase of 16 percent over the 1.9 billion of 2010. Currently, the Muslim world population may account for 7.7 percent of global GDP today.

particular BNM's proactive policy, led to the development of policies and regulations that enable a steady and sound development of the industry.

In the GCC, a 1975 decree authorized the establishment of the Dubai Islamic Bank. Kuwait allowed the creation of the Kuwait Finance House (KFH) in 1977. In Bahrain and Qatar, Islamic banks were created in 1979 and 1982, respectively.[3] Of course, Saudi Arabia had Islamic finance but refrains from labeling financial activities as "Islamic"; the Saudi El Rajhi bank is the GCC's largest Islamic bank.

While Egypt was a pioneer, a disorderly early development of Islamic investment companies under weak regulation and supervision led to the development and later collapse of finance houses, most notably the El Rayan Company. It was mobilizing depositors' resources by offering highly attractive returns and claiming to be *Shari'a* compliant. In fact it instead set up a Ponzi scheme that collapsed in the late 1980s, ruining many small depositors.[4] This episode stained the reputation of Islamic finance in Egypt and beyond, led authorities to remain skeptical on the potential benefits of Islamic finance, and delayed its resurgence in the country. Cautiously, authorities permitted the existence of the first Islamic financial provider, an Islamic window set up by Bank Misr, and the establishment of the first full-fledged Islamic bank, Faisal Islamic Bank, in 1979. However, Egyptian authorities remained circumspect vis-à-vis Islamic finance for a very long time.

Various factors have contributed to the renaissance of Islamic finance. Imam and Kpodar (2010) find that the diffusion of Islamic finance is positively related to the relative size of the Muslim population in a country, income per capita, hydrocarbon exports, political stability, and trade relations with the Middle East. They also find a negative relationship between Islamic finance and interest rates.[5] Essentially, their results point out the *role of champions and resource availability* in fostering the development of

[3] Wilson (2009).

[4] See the Securities and Exchange Commission on Ponzi schemes: www.sec.gov/answers/ponzi.htm. A TV series on the El Rayan episode was aired on Egyptian TV during the month of Ramadan of 2012. See the *Egyptian Gazette*, July 5, 2012, http://213.158.162.45/~egyptian/index.php?action=news&id=20552&title=El-Rayan%20drama%20makes%20waves.

[5] Imam and Kpodar (2010) focus on the diffusion of Islamic banking. They find that "the probability for Islamic banking to develop in a given country rises with the share of the Muslim population, income per capita, and whether the country is a net exporter of oil. Trading with the Middle East and economic stability also are conducive to diffusion of Islamic banking. Proximity to Malaysia and Bahrain, the two Islamic financial centers, also matters. We found that rising interest rates hinder the diffusion of Islamic banking because they raise the opportunity cost for less devout individuals or non-Muslims to put their money with an Islamic bank."

Islamic finance. There is no doubt that the presence of champions has been instrumental in the renaissance of Islamic finance.[6] They have been prominent market participants like Dr. Ibrahim El Naggar in Egypt, or Mr. Salah Kamel and Prince Faisal in Saudi Arabia, founders of El Baraka and Faisal groups, respectively. Champions have also been country authorities such as Malaysia's and Bahrain's central bank governors, most notably Dr. Zeti Akhtar Aziz and Mr. Rasheed Mohammed Al Maraj, respectively, or the founders of the Islamic Development Bank (IsDB), in particular Saudi Arabia. One also has to acknowledge the role played by leaders of organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB), and International Islamic Financial Markets (IIFM).[7] They endeavored to lay the ground rules for the industry and to harmonize them across countries. Champions' efforts were facilitated by resource availability or hindered by the lack thereof. The international wealth redistribution that occurred in the wake of increases in hydrocarbon prices in the early 1970s, early 1980s, and later after a lull, enabled champions (notably in the GCC region) to develop Islamic financial services. The presence of hydrocarbon resources was also a factor in Malaysia but to a lesser extent. Clearly, resource availability was less a factor in the initial renaissance of Islamic finance in Egypt, but later played a role due to the country's close geographical and cultural connection with the GCC countries.

The role of interest rates is pointed out by Imam and Kpodar (2010) as a factor influencing the industry's development. The point confirms the financial intermediation nature of Islamic finance, implying that agents do consider relative returns offered by Islamic and conventional financial services. Also, it is worth noting that periods of financial crisis and occurrences of distress in Islamic financial institutions slow down the industry's expansion. For example, the international financial crisis over 2007 and 2008 slowed down the issuances of *sukuk*s as well as the engagement of large international banks in Islamic finance.[8] Similarly episodes of collapse

[6] Champions mentioned here are provided as examples. These references do not diminish in any way the extraordinary role played by other champions whether at the individual level or the institutional level in national and international contexts.
[7] Other organizations were also established.
[8] The slowdown of issuance of *sukuk*s resulted also from a revisiting of the *Shari'a* compliance of previously issued *sukuk*s by AAOIFI's *Shari'a* board. Islamic banks seem to have better weathered the adverse impact on profitability of the international financial crisis in 2008. Their credit and asset growth performed better than did that of conventional banks over 2008–2009. External rating agencies assessed Islamic banks generally more favorably. See Hasan and Dridi (2010).

of Islamic financial institutions have hurt confidence in the industry and sometimes slowed its development temporarily.[9]

In summary, the development of Islamic finance can be divided into four periods:

- *The establishment period from 1963 to 1976*. The period saw the development of analytical work, international cooperation, and banking activity. Major research across the Muslim world focused on fields that concern Muslims' daily lives. Also, organizations were set up with the objective of establishing and developing cultural and religious relationships across Muslim countries.
- *The spread period from 1977 to 2002*. This period was fueled by the sharp increase in oil prices and wealth accumulation in the Middle East. It witnessed the establishment of more than 100 Islamic banks across the world, such as Dar al-maal al-Islam in 1981 and the Al-Baraka group in 1982.
- *The international recognition period from 2003 to 2009*. This period witnessed a global acceptance of the development and significance of Islamic finance by regulators across the world, including notably in China, Europe, and the United States. Also, international banks with worldwide presence showed growing interest in Islamic finance and many of them engaged in Islamic finance operations, including through Islamic windows. This is the case with banks such as Citibank (U.S.), ANZ (Australia), ABN Amro (Netherlands), Goldman Sachs (U.S.), HSBC (UK), Deutsche Bank (Germany), Société Générale (France), Saudi-American Bank (U.S.–Saudi Arabia), and Saudi-British Bank (UK–Saudi Arabia). There are to date more than 200 Islamic financial institutions in over 70 countries around the world.[10]
- *The evaluation period from 2009 to the present*. During this period, the growth momentum of Islamic financial assets that was maintained during the global financial crisis (compared to conventional financial assets) conveyed to many, including regulators, policy makers, bankers, and economists, that the asset-backed nature of Islamic finance can contribute to the stability of financial markets.

[9] As the collapse notably of the Ryan finance house in Egypt demonstrates, whatever were its reasons. See also, for example, Starr and Yilmaz (2007) for a Turkey 2001 distress episode. The issue is the importance of the reputation risk for the finance industry.

[10] Saidat A. Otiti, "Evolution of Islamic Banking & Finance," August 2001, http://www.mpac-ng.org/archived-article/636-evolution-of-islamic-banking-a-finance.pdf.

CORE PRINCIPLES

The primary sources of *Shari'a* are the Quran and the Sunna.[11] *Shari'a* is the body of jurisprudence accumulated over time based on interpretations of the Quran and the Sunna. These interpretations and rulings are the outcome of methods of reasoning and rules of interpretation known as *fiqh*. Accordingly, engaging in Islamic finance entails conducting business in accordance with the *Shari'a* body of Islamic jurisprudence as derived from the Quran and the Sunna using *fiqh*.

As applied to finance, *Shari'a* prohibits the charging or paying of interest (*riba*), excessive uncertainty in contracts (*gharar*), gambling and chance-based games (*qimar*), and investment in certain forbidden (*haram*) industries. This means inter alia: (1) an acquisition target industry is ethically screened, (2) debt-to-equity and income ratios are within specified *Shari'a*-accepted boundaries, and (3) *Shari'a*-compliant financing is used for the acquisition and funding of only permissible activities—that is, any activities that are not prohibited by Islamic law.

To be *Shari'a* compliant, financial transactions need be governed by shared business risks and returns and must deal with religiously acceptable services, trade, or products, with clear and transparent rights and obligations of parties to the contract. Islamic finance is limited to financial relationships involving real economy entrepreneurial activity. In particular, conventional securitization needs to feature sufficient investor ownership that incorporates an entrepreneurial stake in real economic activity within an interest-free structural arrangement. A core economic feature of Islamic finance is to have the rate of return of real economic activity drive the allocation of financial resources.

In practice, principles guiding the conduct of Islamic financial business are characterized by the following features:

- *Prohibition against the payment and receipt of a fixed or predetermined rate of interest*. This is replaced by profit and loss sharing (PLS) arrangements where the rate of return on financial assets held in banks is not known and not fixed prior to the undertaking of the transaction. The actual rate of return can be determined on the basis of actual profits accrued from real-sector activities that are made possible through the productive use of financial assets.
- *Requirement to operate through Islamic modes of financing*. These modes affect both the assets and liabilities sides of a bank's balance

[11] Sunna is the way of life prescribed as normative for Muslims on the basis of Prophet Mohamed's teachings and practices and the interpretations of the Quran.

sheet and can be divided into two groups: those that are based on the PLS principle (core modes) and those that are not (marginal modes).

- *Investment deposits*. Such deposits are not guaranteed in capital value and do not yield any fixed or guaranteed rate of return. In the event banks record losses as a result of bad investment decisions, depositors may lose part or all of their investment deposits. The only contractual agreement between depositors and banks is the proportion (ratio) according to which profits or losses are to be distributed.
- *Demand deposits*. Such deposits are guaranteed in capital value, although no returns are paid on them. The reason to justify the capital value guarantee is the assumption that demand deposits have been placed as *amana* (for safekeeping). Hence, they belong at any time to depositors.
- *Risk sharing*. The terms of financial transactions need to reflect a symmetrical risk/return distribution that each party to the transaction may face.
- *Materiality*. A financial transaction needs to have a "material finality" that is directly or indirectly linked to a real economic transaction.

Islamic finance has developed on the basis of the foregoing principles. They have led Islamic banks to adopt the type of balance sheet stylized in Appendix 1A. The *risk sharing* is enshrined in the use of the *mudaraba* contract, which is a contract between an owner of financial resources (*rab-ul-mal*) and someone who takes charge of managing them (*mudarib*) on behalf of the owner for a fee and a share of profit. This type of contract is extensively used in deposit taking where the bank is the manager of the resources and the depositor is the owner. It can also be used in extending financing by the bank to an economic agent or entrepreneur with the bank, this time taking the role of owner and the entrepreneur that of resource manager. Under that type of contract the bank, the owner of the funds, does not intervene in the management of the funded project. In a *mudaraba* contract, the bank is entitled to receive from the entrepreneur the principal of the sum it "invested" at the end of the period stipulated in the contract if, and only if, profits have accrued. If, on the contrary, the enterprise's books show a loss, the bank would not be able to recover its investment. For understandable risk management reasons, *mudaraba* is not a preferred contract for funding risk-bearing assets for an institution offering Islamic financial services (IIFS).

Musharaka contracts provide a better opportunity than *mudaraba* to monitor and control projects funded by the Islamic bank. Indeed, in a *musharaka*, the bank becomes an active shareholder of the project and all partners may concur in the management of the enterprise and hold direct voting rights. *Musharaka* contracts are not extensively used by Islamic banks because of their generally longer maturity and the weak institutional infrastructure found in many jurisdictions where Islamic finance is present; this similarly limits the development of conventional equity financing.

The *materiality* principle leads to the financing by the bank of a real economic transaction for the account of the economic agent needing the financing. Materiality is intrinsic to the *ijara* or leasing contracts as well as to the *murabaha*. The latter is essentially trade financing where the financier purchases the needed commodity for the account of the financed, which takes spot delivery and pays back the financier with a markup at a later date.

The *prohibition of riba* excludes the payment of interest to the *amana* depositor, basically a demand depositor who needs the guarantee of principal and forgoes remuneration for that. The *mudaraba* depositor, on the contrary, may enjoy the opportunity of a return but also may face the risk of a loss.[12] *Amana* deposit face values are guaranteed, and they are redeemable on demand.

The no exploitation principle also includes the idea of no excessive risk taking, or no risk taking in the nature of gambling. It also covers issues of asymmetric information, as benefiting from nonshared information entails an unfair contract and consequently exploitation. The prohibition against financing of harmful activities is self explanatory.

In principle, the combination of risk sharing and prohibition of *riba* entails profit and loss sharing arrangements and a balance sheet structure as in Appendix 1A.[13] It should limit the impact of external shocks on Islamic banks' balance sheets. Indeed, an Islamic bank's balance sheet incorporates an intrinsic hedge in principle, as a loss of asset value would translate into a change of value of the pool of resources that funded it, generally mostly investment accounts. Islamic banks pool depositors' funds in providing them with professional investment management with associated returns and risks. Neither the face value of investment deposits nor their return is guaranteed. Investment depositors share in the bank's net profit (or loss) according to the profit and loss sharing (PLS) ratio stipulated in their contracts. From the perspective of investment account holders (IAHs), Islamic banks behave like mutual funds with a variable net asset value.

[12] The prohibition of payment and receipt of a fixed or predetermined rate of interest is replaced by profit and loss sharing (PLS) arrangements where the rate of return on financial assets held in banks is not known and not fixed prior to the undertaking of the transaction. The actual rate of return can be determined on the basis of actual profits accrued from real-sector activities that are made possible through the productive use of financial assets.

[13] See Usmani (2002) for the different modes of financing.

Fiduciary responsibility, regulatory and supervisory requirements, and risk management have led to a dominance of *murabaha* and *ijara* modes of financing in Islamic banks' balance sheets (see Figure 1.1). One could have expected *mudaraba* and *musharaka* to take a larger place because of their risk sharing features, core to Islamic finance. Mitigation of these risk sharing features requires evolved contractual, legal, and conflict resolution arrangements. However, though progress has been achieved, these arrangements are often weak in many countries and accordingly the development of equity markets and *mudaraba* and *musharaka* transactions has been slow.

In Islamic banks there are two major types of fund providers: (1) current account holders and (2) unrestricted IAHs and restricted IAHs. Islamic banks offer separate investment accounts and current accounts, the first drawable at maturity and the second drawable on demand. Current accounts are based on *qard* contracts. The investment accounts use *mudaraba* or *wakala* contracts whereby fund providers are passive partners. These account holders require a degree of liquidity to be maintained by the IIFS to meet their requirements for withdrawals. The default risk of not paying a return to depositors is eliminated under the Islamic banking model. Nevertheless, the failure to reward depositors could lead to a substantial withdrawal of deposits and the risk of bankruptcy. As current account holders do not participate in the profits of the IIFS's business activities, a sound repayment

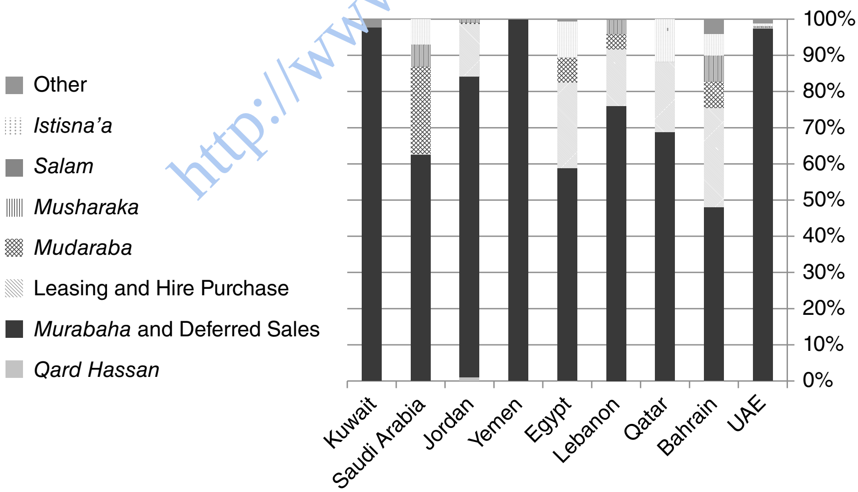

FIGURE 1.1 Murabaha and Ijara: Dominant Modes of Financing, 2008
Source: Salman Syed Ali, "Islamic Banking in the Mena Region," Islamic Development Bank, Islamic Research and Training Institute, World Bank, 2011, Figure 5.

capacity is required to meet fully cash withdrawal requests when they arise. IIFSs may rely heavily on funds provided by current account holders. Repayment by the IIFS of the principal amounts deposited by current account holders is guaranteed without any rights to share in profits, as the current account holders do not share in the risks of the IIFS. Unrestricted IAHs are investors who participate in the uncertainties of an IIFS's business; therefore, they share in profits and bear losses arising from investments made on their behalf, to the extent of their share. Apart from general withdrawal needs, the withdrawals made by IAHs may be the result of (1) lower than expected or acceptable rates of return and/or (2) noncompliance by the IIFS with *Shari'a* rules and principles in various contracts and activities. Table 1.1 shows a comparison of Islamic and conventional banking frameworks.

TABLE 1.1 Characteristics of Islamic and Conventional Banking

Characteristic	Islamic Banking	Conventional Banking
Nominal value guarantee of:		
Demand deposits	Yes	Yes
Investment deposits	No	Yes
Equity-based system where capital is at risk	Yes	No
Rate of return on deposits	Uncertain, not guaranteed	Certain and guaranteed
Mechanism to regulate final returns on deposits	Depending on banks' performance/profits from investment	Irrespective of banks' performance/profits from investment
PLS principle is applied	Yes	No
Use of Islamic modes of financing:		
PLS and non-PLS modes	Yes	No
Use of discretion by banks with regard to collateral	Possible for reducing moral hazard in PLS modes Yes in non-PLS modes	Yes always
Banks' pooling of depositors' funds to provide depositors with professional investment management.	Yes	No

Source: L. Errico and M. Farahbaksh, "Islamic Banking: Issues in Prudential Regulation and Supervision," IMF Working Paper WP/98/30 (Washington, DC: International Monetary Fund, 1998).

APPENDIX 1A: STYLIZED BALANCE SHEET OF AN ISLAMIC BANK

TABLE 1A.1 Theoretical Balance Sheet of an Islamic Bank Based on Maturity Profile

Assets	Liabilities
Short-term trade finance (cash, *murabaha*, *salam*)	Demand deposits (*amana*)
Medium-term investments (*ijara*, *istisna'a*)	Investment accounts (*mudaraba*)
Long-term partnerships (*musharaka*)	Special investment accounts (*mudaraba*, *musharaka*)
Fee-based services (e.g., *kifala*)	Reserves
Nonbanking assets (property)	Equity capital

TABLE 1A.2 Theoretical Balance Sheet of an Islamic Bank Based on Functionality

Assets	Liabilities
Cash balances	Demand deposits (*amana*)
Financing assets (*murabaha*, *salam*, *ijara*, *istisna'a*)	Investment accounts (*mudaraba*)
Investment assets (*mudaraba*, *musharaka*)	Special investment accounts (*mudaraba*, *musharaka*)
Fee-based services (e.g., *kifala*)	Reserves
Nonbanking assets (property)	Equity capital

Source: Iqbal and Van Greuning (2008).

APPENDIX 1B: GLOSSARY OF SELECTED ISLAMIC FINANCE TERMS

Term	Quick Definition	Full Definition
Amana	Trustworthiness, faithfulness, and honesty	*Amana* is also used to define a situation in which one party is keeping another person's property in trust. This is the way in which the term is most commonly applied, especially within the confines of Islamic commercial law. The term is also applied when referring to goods on consignment, in custody, or on deposit.

(*continued*)

APPENDIX 1B (*Continued*)

Term	Quick Definition	Full Definition
Arbun	Down payment	*Arbun* describes the deposit that the buyer makes to the seller at the same time as making the agreement to complete payment by a set date.
Gharar	Uncertainty	*Gharar* refers to something that is not completely set in stone within a contract. It is a fundamental disagreement between Islamic and conventional U.S./UK law, and Islam does not recognize the need for related practices such as speculation, derivatives, and short-selling contracts.
Islamic finance	Financial services specifically designed to adhere to Islamic law or *Shari'a*	Although these financial services are designed for Muslims, they are not exclusively available to Muslims. Non Muslims can also provide and buy the services.
Ijara	Islamic leasing agreement	An *ijara* enables the financier to seek profit through the leasing of assets (house, car, etc.) rather than by actually lending money. *Ijara wa iqtina* is an extension of the concept and is a hire purchase agreement.
Maysir	Gambling	*Maysir* is forbidden in Islam and therefore the concept fundamentally disagrees with standard financial practices such as speculation, insurance, and derivative contracts.
Mudaraba	Investment partnership	This is the financial partnership between the investor (*rab-ul-mal*) and another party (*mudarib*). The contract will set out how profits will be shared, and losses are absorbed by the *rab-ul-mal*. The *mudarib* forgoes some of the expected income in case of losses.
Mudarib	Investment manager or entrepreneur partaking in a *mudaraba*	It is the *mudarib*'s responsibility to ensure that the investor's money is taken care of and is profitable in its investments. In turn, the *mudarib* gets a share of the profits. The role is very similar to a mutual fund manager or a private equity general partner.

Term	Quick Definition	Full Definition
Murabaha	Purchase and resale	The capital provider purchases the required asset or product (for which a loan would otherwise have been taken out) from a third party. The asset is then resold at a higher price to the capital user. By paying this higher price in installments, the capital user effectively gets credit without paying interest. (Also see *tawaruq*, the opposite of *murabaha*.)
Musharaka	Profit and loss sharing	This is considered the purest form of Islamic financing, because profits and losses are shared in proportion to the investment made by each investor. Each partner within the *musharaka* contributes capital and can make executive decisions; however, they are under no obligation to do so. It is basically a partnership that involves owning voting stock in a limited company.
Riba	Interest	*Riba* is forbidden by the Quran, which forbids any return of money on money, whatever type of interest it may be.
Shari'a	Islamic law	*Shari'a* refers to the law set down in the Quran and performed by example by Prophet Mohamed (PBUH). Any product purporting to be *Shari'a* must adhere to Islamic law in all respects, and to ensure this, a company will usually appoint a *Shari'a* board that will oversee the development and implementation of all *Shari'a* products to ensure they comply.
Shari'a adviser	Person who advises on Islamic financial law	A *Shari'a* adviser is generally an Islamic legal scholar who has been classically trained and has the expertise and knowledge to ensure that products comply with *Shari'a*. Some work individually to advise companies, but most are employed as part of a *Shari'a* board to ensure full compliance.
Shari'a compliant	Observing Islamic law	The *Shari'a* board ensures that products comply with *Shari'a*. Many financial products use the term *Shari'a compliant* to signal that the product has followed the law to the letter.

(*continued*)

APPENDIX 1B (*Continued*)

Term	Quick Definition	Full Definition
Sukuk	A bond	In conventional terms *sukuk*s and bonds are not quite the same, as a bond is asset backed and the term *sukuk* describes the proportionate beneficial ownership in the asset itself.
Takaful	Islamic insurance	Because the concept of insurance relates to uncertainty, which could then be related to interest and gambling, *takaful* takes a different approach. The arrangement can be summed up as a charitable collection of funds based on the idea of mutual assistance.
Tawaruq	The Islamic way of obtaining cash	This is a liquidity instrument to mobilize cash. It involves buying something on deferred credit and selling the item on to get cash. As a result, cash has been obtained without taking out a loan and paying interest.

Source: Adapted from Canadian Money Advisor at www.canadian-money-advisor.ca/archives/2006/05/islamic+finance+terms+glossary.html.

APPENDIX 1C: GLOSSARY OF ARABIC FINANCE TERMS

Term	Definition
Fatwa	Legal opinion issued by a qualified scholar on matters of religious belief and practice.
Fiqh (Islamic jurisprudence)	It refers to Islamic jurisprudence that covers all aspects of life: religious, political, social, and economic. *Fiqh* is mainly based on interpretations of the Quran and Sunna (sayings and deeds of the Prophet).
Fiqh al-Muamalat	Islamic commercial jurisprudence.
Halal	That which is permissible according to *Shari'a* law.
Haram	Unlawful according to the *Shari'a*. It indicates transactions that are not permissible under Islamic law.
Hibah	Literally, gift. A gift awarded voluntarily in return for a loan.
Ju'ala (service charge)	A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements, and trust services.

Term	Definition
Kifala	It is a pledge given to a creditor that the debtor will pay the debt, fine, or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.
Qard hassan (beneficence loan)	A zero-return loan that the Quran encourages Muslims to make to the needy. Banks are allowed to charge borrowers a service fee to cover the administrative expenses of handling the loan. The fee should not be related to the loan amount or maturity.
Quran	Islamic scriptures believed by Muslims to be God's revelation to the Prophet.
Sunna	Deeds of the Prophet.
Umma	Community of the faithful within Islam.
Wadiah	A safe custody contract between the depositor (customer) and the custodian (bank).
Wikala	An agency contract that may include in its terms a fee for the agent. The same contract can also be used to give a power of attorney to someone to represent another's interests.
Zakat	Religious tax to be deducted from wealth to be paid to the needy.

Source: Adapted from El-Hawary, Grais, and Iqbal (2004) and the glossary of the International Islamic Financial Market (IIFM) website (www.iifm.net).