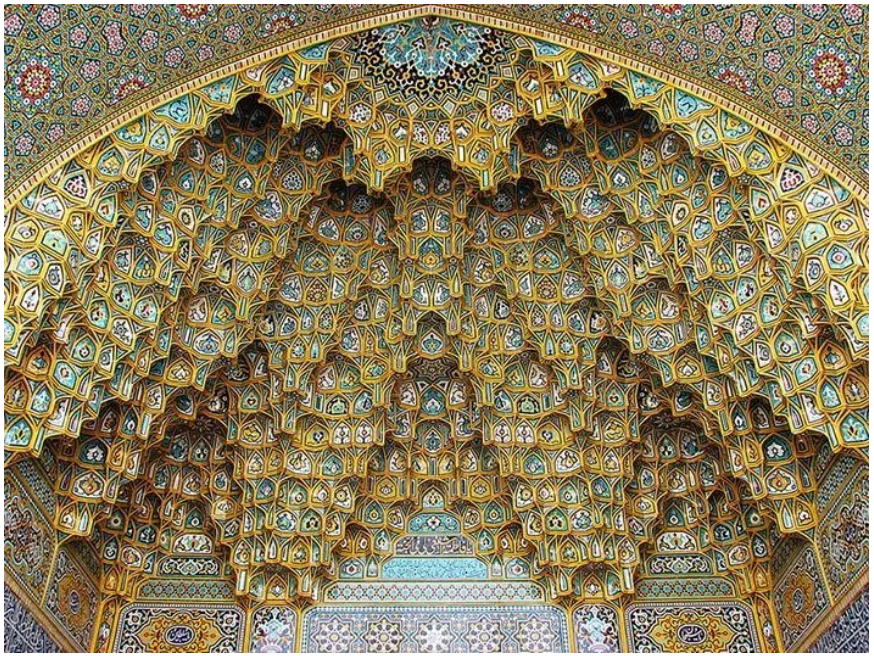
Islamic Finance Awareness Program



27-30 November 2017

Tashkent, Uzbekistan

Islamic Research and Training Institute

A Member of Islamic Development Bank Group

Agenda

Day 1

Introduction to the IDB Group

Origins of Islamic Finance and the IFS Industry

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Day 2

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Islamic Capital and Money Markets

Takaful and Re Takaful

Islamic Social Finance

Shari'ah Governance

Day 3

Sukuk

Case Studies in Islamic Finance

Yahya Rehman

- Yahya Rehman is a Development Economist and Advisory Services Leader with over 17 years of experience in Islamic finance, strategy development, feasibility studies, business planning, capacity building and project management across Europe, Middle East, Asia and the Americas.

- Yahya is a lead professional in the Advisory and Technical Assistance Division at IRTI, providing advisory, capacity building, training and technical assistance services to promote Islamic Economics and Finance. He has headed IRTI's advisory and technical assistance portfolio across IDB's 57 member countries and other regions with Muslim communities.

- Prior to joining IRTI, Yahya was Vice President of Development Management Services at Capitas Group International (CGI), a joint venture between the Islamic Corporation for the Development of the Private Sector (ICD) and New York based holding company Capitas Group.

- Yahya has previously worked in management positions in KPMG Saudi Arabia, Ernst & Young Bahrain and Accenture in the United Kingdom

- Yahya is a Rhodes Scholar and has a Masters in Development Management from the London School of Economics (LSE), UK, a Masters in Politics and Economics from the University of Oxford, UK and a Masters and B.Sc. (Hons.) in Economics from the International Islamic University, Islamabad, Pakistan. He is also a Certified Islamic Banker and a Certified Expert in Climate and Renewable Energy Finance.

Himmatilla Boriev

- Himmatilla Boriev is an experienced Islamic Banking and Finance professional, with over 10 years of work experience in the development banking sector, worked in designing, implementing and running various projects in East Asia, Central Asia, Europe and the Middle East.

- Himmatilla is a Senior Islamic Finance specialist at IRTI, mainly responsible for projects from the Central Asia and Europe.

- Prior to IRTI, Himmatilla worked in the Islamic Corporation for the Development of the Private Sector (ICD) for number of years, where he was a Senior Investment Manager responsible for equity investments in non-banking financial institutions in the Central Asia, Europe and the Middle East. He initiated and managed establishment of 9 leasing companies, and 3 advisory services and consultancy companies in various IDB Member Countries. He sat in the Boards of 2 leasing companies, and advised the Board of 7 leasing companies in internal audit, business continuity, corporate governance and client relations.

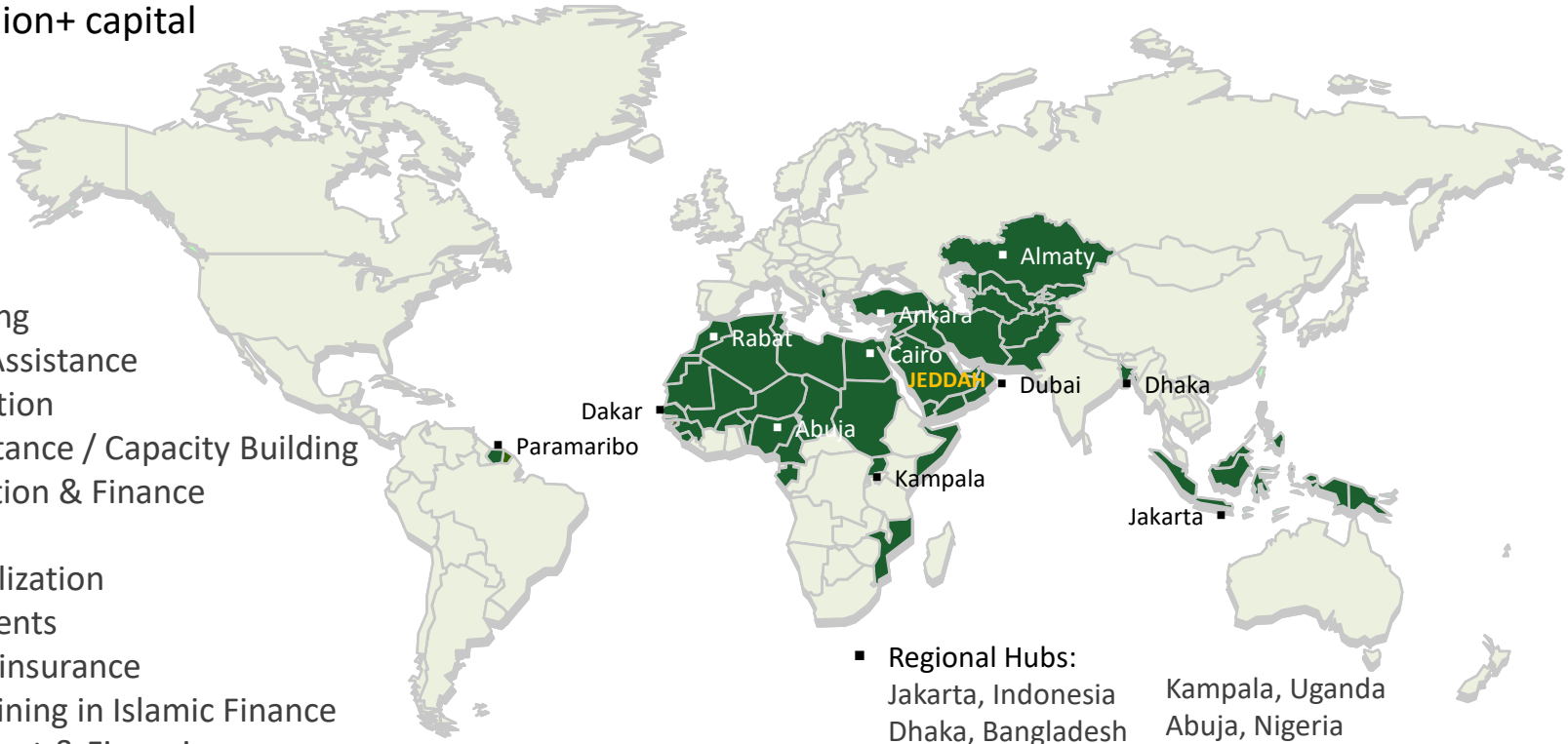
- Himmatilla has a Master of Science degree in International Economics and Strategy from St Andrews University (UK), and a Bachelors Degree in International Economic Relations from National University of Uzbekistan. He also has a Diploma from Institute of Directors (UK) and he is Certified Islamic Banker from CIBAFI.

- Himmatilla's personal interests include entrepreneurship, start ups, advisory and technology innovations.

IDBG Vision

"To foster the economic development and social progress of member countries and Muslim communities individually and collectively in accordance with the principles of Shari'ah"

- 57 member countries
- USD 150 billion+ capital
- Rated AAA*



- Project Financing
- Development Assistance
- Poverty Alleviation
- Technical Assistance / Capacity Building
- Trade Cooperation & Finance
- SME Financing
- Resource Mobilization
- Equity Investments
- Insurance & Reinsurance
- Research & Training in Islamic Finance
- Awqaf Investment & Financing
- Scholarships
- Emergency Relief
- Public and Private Sector Advisory

- Headquarters:
  Jeddah, Saudi Arabia

- Regional Hubs:
  Jakarta, Indonesia
  Dhaka, Bangladesh
  Almaty, Kazakhstan
  Ankara, Turkey
  Cairo, Egypt
  Dubai, United Arab Emirates
  Kampala, Uganda
  Abuja, Nigeria
  Rabat, Morocco
  Dakar, Senegal
  Paramaribo, Suriname

IDBG Entities

Lead the Development of a Dynamic and Comprehensive Islamic Financial Services Industry

1981

Encourage Intra-trade among Organization of Islamic Cooperation (OIC) Member Countries

1994

Provide Shari'ah-compliant Export Credit Insurance and Insurance Facilities

2008

1999

Promote Private Sector Development by Providing a Wide Range of Shari'ah-compliant Financial Products and Services

2005

Improve the Income of the Poor by Creating Jobs and Promote the Development of Human Capital

- Leading and sustaining the development of a dynamic and comprehensive Islamic Financial Services Industry (IFSI)
- Supporting the socio-economic development of member countries and Muslim communities in non member countries

Vision

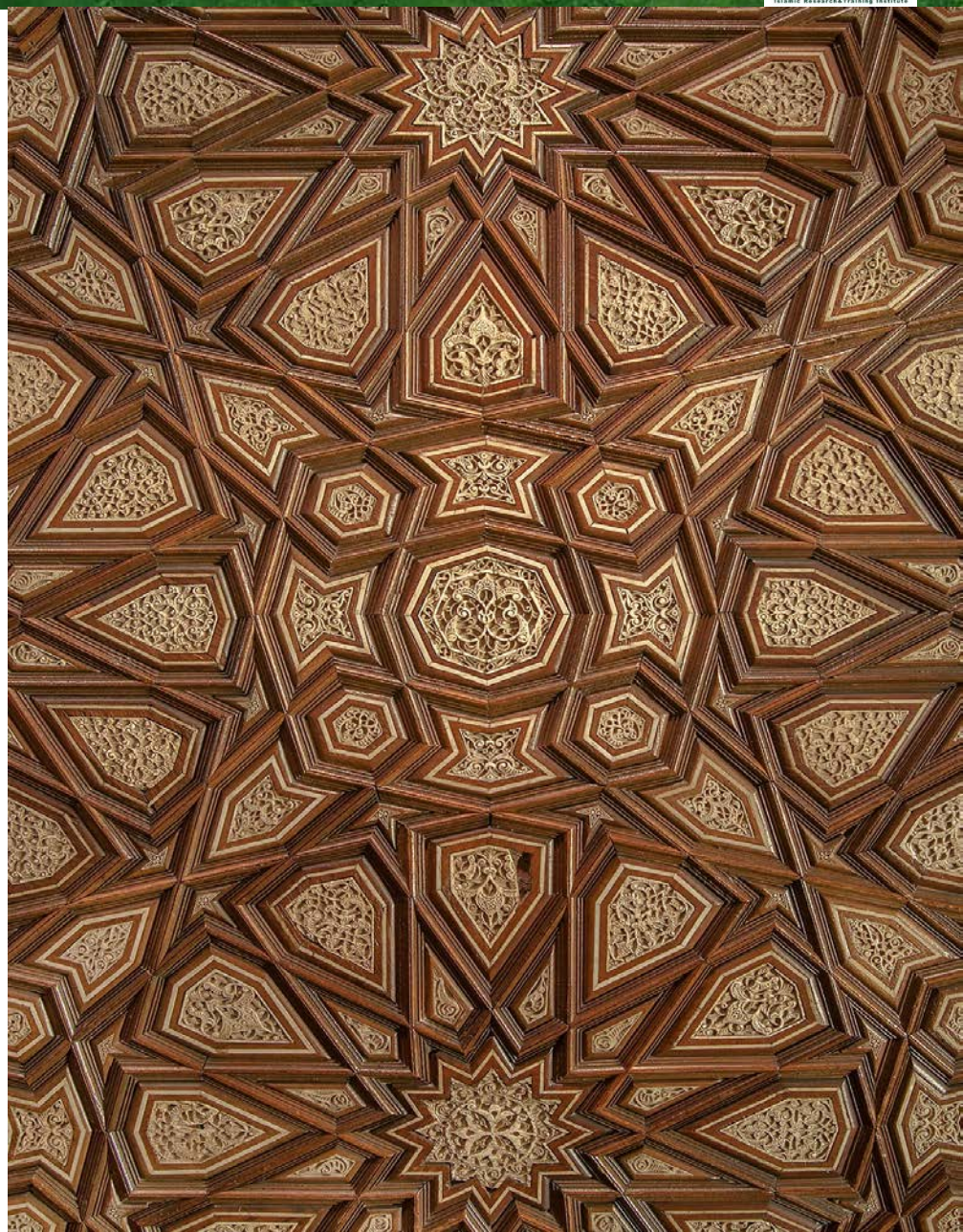
"To be the global knowledge center for Islamic economics and finance by 1440H"

Mission

"To inspire and deliver cutting edge research, capacity building, advisory and information services in the area of Islamic economics and finance"

As a center of excellence, IRTI undertakes research, conducts training, provides advisory services and enhances capacity building in basic and applied Islamic economics, banking and finance

Origins of Islamic Finance



What is the basis of Islamic finance?

Islamic finance is based on Sharī‘ah, the value-based legal framework of Islam, which is extracted from the revealed scripture, Al Qur’an, and teachings of the Prophet (Peace be upon him).

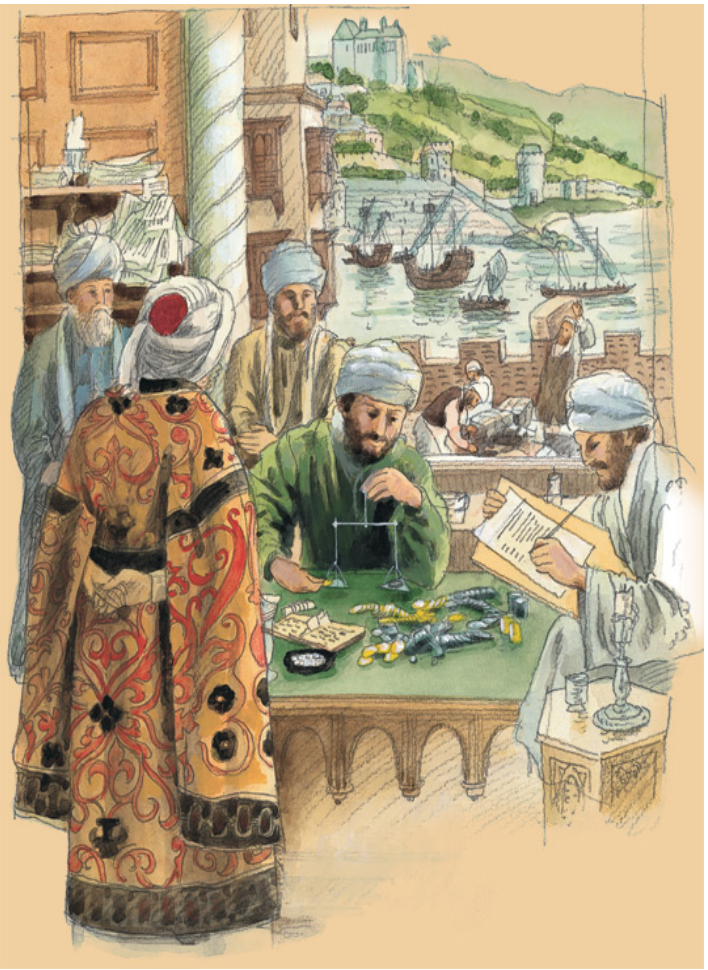
This framework provides guidelines for people to follow in all aspects of life so that they live in harmony with each other and with nature and so that they do not encroach on the rights of others and do not commit injustice towards themselves and/or others.

What are the origins of Islamic finance?

The values and principles espoused by Islamic finance are universal in nature and their origins go back in time even before the advent of Islam. These values are shared not only by all the Abrahamic Faiths but also by other religions. Their adoption and implementation contribute towards the formation of a sustainable society based on honesty, equitable wealth distribution and social justice.

During the time of Prophet Muhammad (PBUH), he implemented reforms into the way business was conducted and banished unfair and exploitative practices, based on injunctions derived from the Qur'an. He thus brought back values into business transactions by encouraging people to be fair and just in their dealings and enforcing the sanctity of contracts.

Is Islamic finance a new phenomenon?



Islamic finance is not a new invention. In fact, a number of concepts and products being used by modern banks have their roots in practices that were prevalent in the Muslim world long before they came to the West.

Examples of banking services:

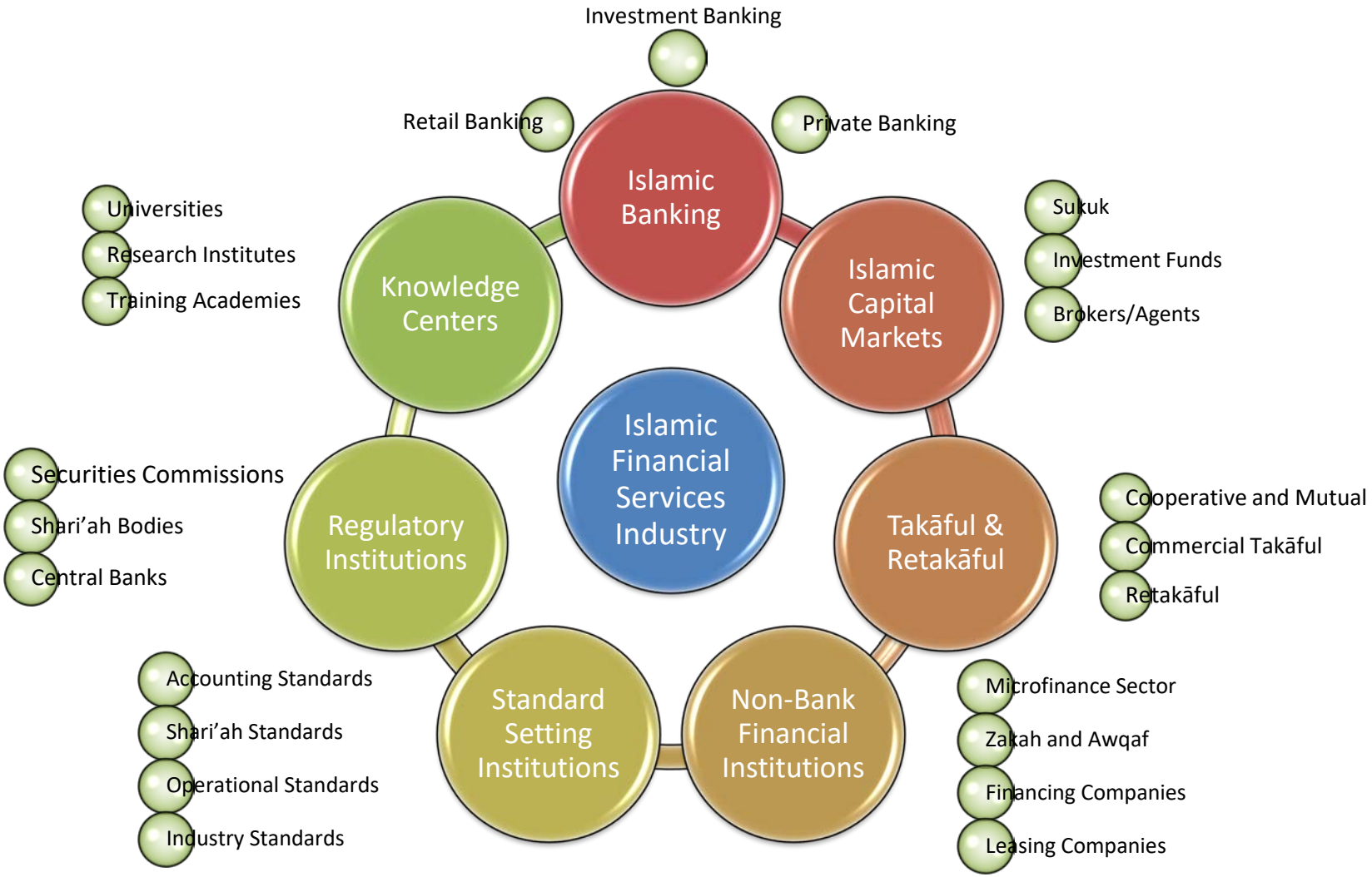
- *Sakk*, (Arabic origin of the word 'cheque') was used to pay for wages and grains delivered to state warehouses by the second caliph of Islam, Umar Ibn Al Khattab.
- *Suftaja*, an instrument combining the features of traveler cheques and letters of credit, was used in trade.
- *Ḥiwālah*, an instrument similar to modern day remittances or credit transfer.
- *Wadī'ah*, a service used for safekeeping and deposit, much like is practiced by modern banks.

The advanced state of these practices led Adam Smith to acknowledge the same in his book, 'An Inquiry Into the Nature and Causes of the Wealth of Nations' (Book V, Page 2), where he mentioned:

"Among nations of shepherds, a more advanced state of society, such as we find it among the Tartars and Arabs,…"

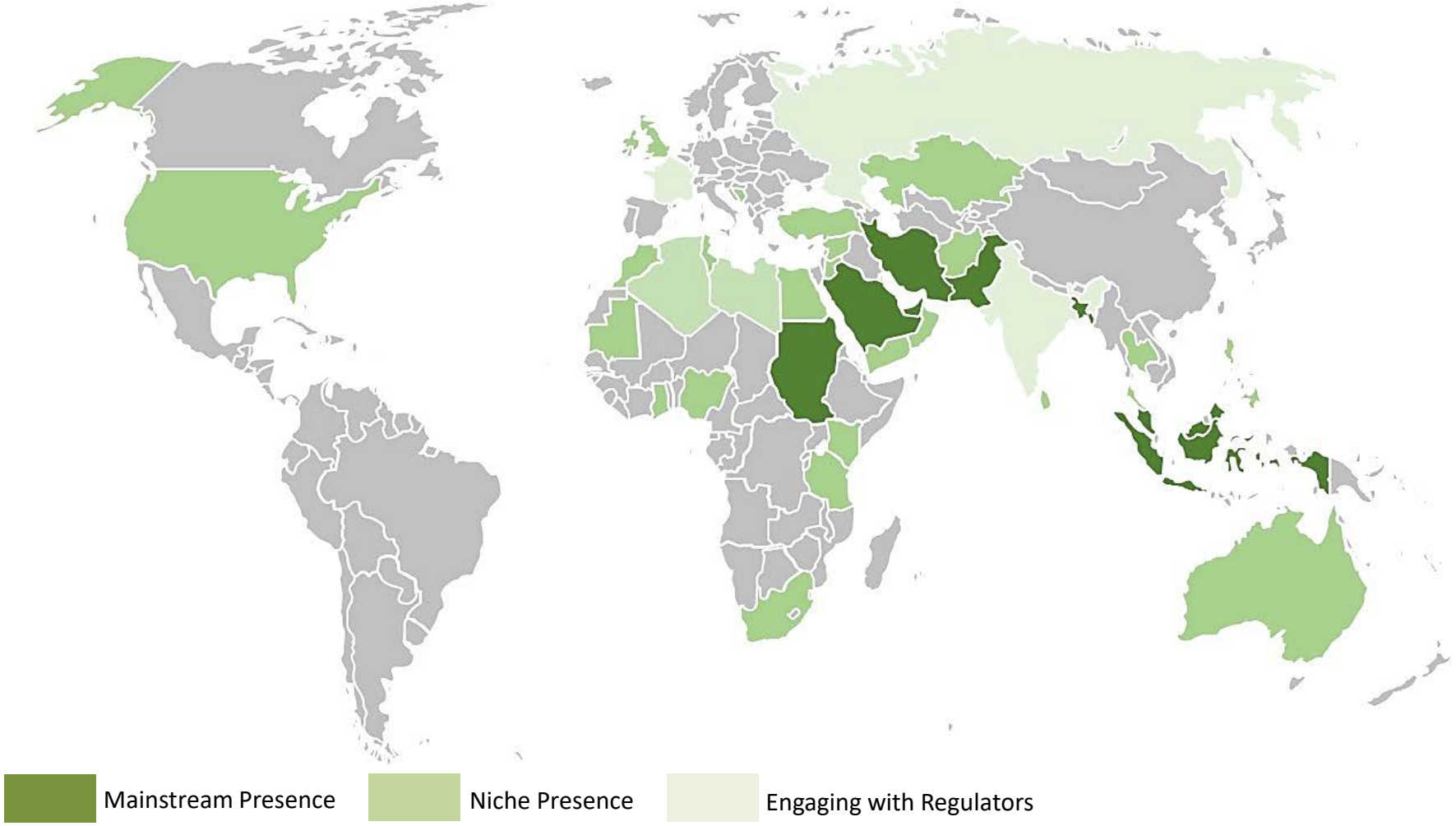
The Islamic Financial Services Industry

What are the key components of the Islamic Financial Services Industry?



What is the current state of the Islamic Financial Services Industry?

The Islamic Financial Services Industry has expanded from a niche to a sector with global footprint

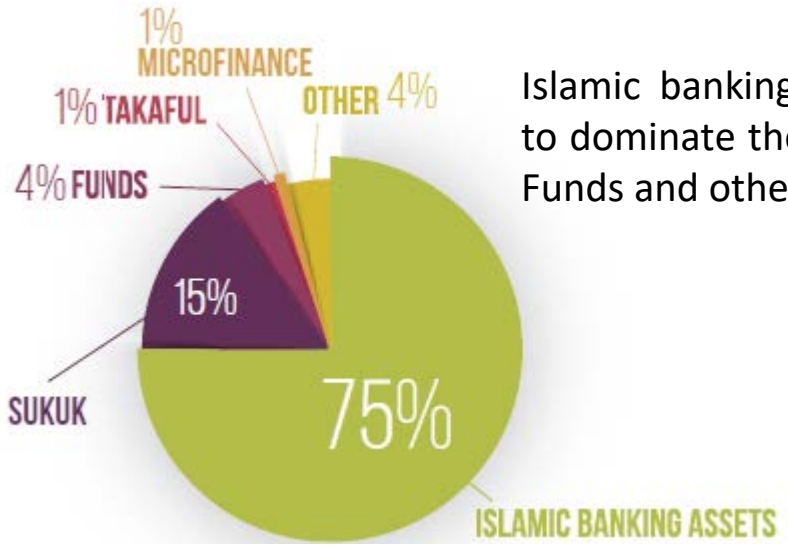


Source: KFHR

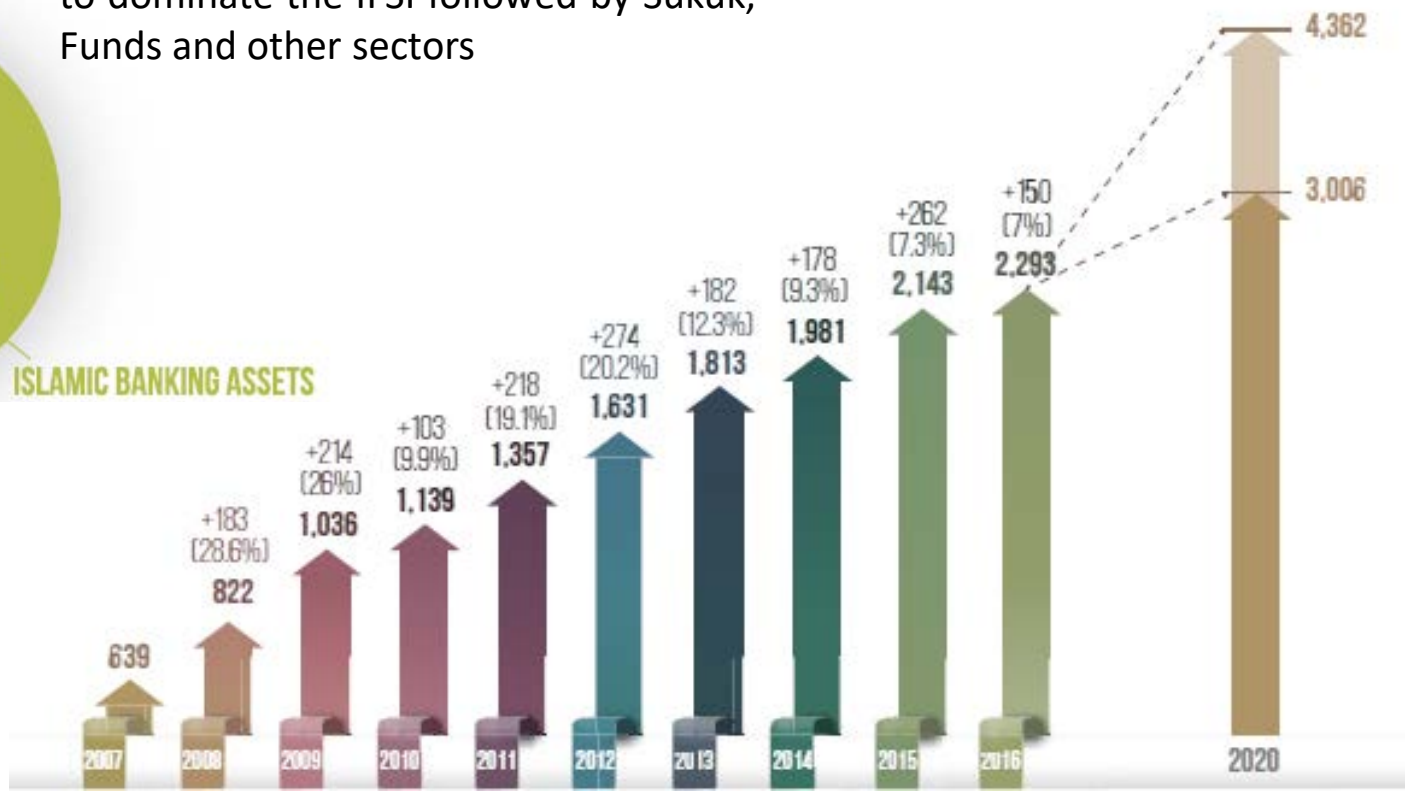
Landscape of the Islamic Financial Services Industry

What is the current size and break up of the Islamic Financial Services Industry?

The IFSI's size was estimated at around USD 2.29 Trillion at the end of 2016 with potential forecasted size between USD 3 to 4.36 Trillion by 2020.



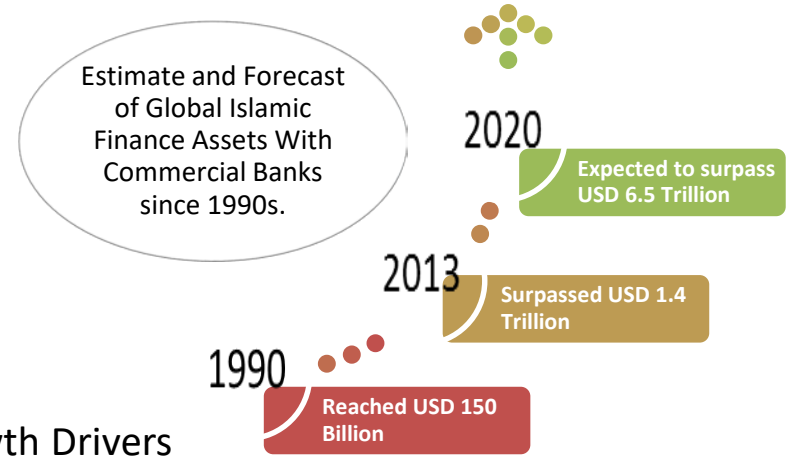
Islamic banking sector assets continue to dominate the IFSI followed by Sukuk, Funds and other sectors



Source: GIFR 2017

What are the emerging trends in the Islamic Financial Services Industry?

The Islamic Financial Services Industry has been the fastest growing segment in the global financial services industry with a 15% - 20% annual growth rate over the past decade. The industry is poised to grow even further with the increased attractiveness of the industry due to its resilience to the 2008 crisis and increased demand for Islamic financial products and services, such as Sukuk and Islamic microfinance.



Key Industry Growth Drivers

Islamic Banking

- Islamic Banking is an attractive proposition to new markets due to its proven resilience to the 2008-2009 financial crisis
- Increased trade among OIC countries and opening up of Islamic Finance in new jurisdictions provide bigger pool of Islamic financial markets and instruments

Islamic Capital Markets

- Increasing demand for short term Sukuk and ethical forms of investments
- Increasing range of investment asset classes
- Existence of funding gaps and increasing infrastructure needs in countries

Non-Bank Financial Institutions

- Islamic Microfinance opens up new markets through the offering of services to under banked and low income groups
- The development of Awqāf properties helps to introduce Islamic finance instruments to new markets

Takāful & Retakāful

- Low penetration rates point to untapped markets
- Increased service offerings in Bancataful and Microtakāful are opening up new markets
- Increasing range of investment asset classes

Source: KFHR, MIFC

Main Features of Islamic Finance

What are the main Sharī‘ah principles which govern Islamic finance?

The sustainability and viability of Islamic finance rely on the implementation of some basic principles of the *Sharī‘ah*.

Islamic transactions should strictly adhere to the permissible (*halal*) and abstain from the prohibited (*haram*). The term *halal* encompasses everything which is good for the community and does not cause harm, whereas the term *haram* encompasses everything which promotes or leads to harm and is not good for the community.

The following are the main Sharī‘ah principles which govern Islamic finance:

- ✓ Permissibility of trade
- ✗ Prohibition of usury and interest-based transactions (Ribā)
- ✗ Prohibition of gambling and excessive speculation (Maysir)
- ✗ Prohibition of ambiguity in transactions (Gharar)
- ✗ Prohibition of dealing with harmful commodities

Main Features of Islamic Finance

What are the main Sharī‘ah principles which govern Islamic finance?

Permissibility of trade: Trading is deemed to be the natural way to deal with each other, as long as there is equity, transparency and fairness in transactions, and dealings are not in prohibited or undesirable commodities and services. Sharī‘ah puts a lot of emphasis on contracts such that every transaction has to be backed by a tradable asset, and risks and rewards are shared equitably among the contracting parties.

Prohibition of usury and interest-based transactions (Ribā): Contracts where one party is unjustly enriched at the expense of the other party are forbidden. The lender is not involved in any productive activity and does not bear any risk to justify the extra compensation in the form of interest since the loan is backed by a collateral. Usury and interest are thus seen as unfair and a form of economic exploitation.

There are two types of Ribā:

1. Ribā Al Duyun (interest from loans)
2. Ribā Al Fadhl (interest from differentials in exchange transactions)

What are the main Sharī‘ah principles that govern Islamic Finance?

Prohibition of usury and interest-based transactions (Ribā)

1. Ribā Al Duyun (interest from loans): This refers to the interest amount in a loan transaction which a lender receives over and above the principal. If the borrower fails to pay on time, the lender levies additional interest. In this transaction, money begets money and no specific activity is performed by the lender to justify the excess compensation and this is unfair to the borrower. This is similar to the interest-based loans offered by banks and other financial institutions. This type of interest was also banned in early teachings of Christianity and Judaism.

2. Ribā Al Fadhl (interest from differentials in exchange transactions): It is defined as an excess compensation derived from a trading transaction without any counter value justifying the excess. It arises from the trading of currencies such as gold, silver and from homogeneous commodities such as wheat, barley, dates and salt. During the time of the Prophet, people would trade commodities of different types, nature and qualities. For example, individual A would trade 5kg of low quality dates now with individual B on credit, and individual B has to give back to individual A 1kg of high quality dates one year from now. The differential in the transaction and the criteria used cannot be properly justified and thus is unfair to one party.

What are the main Sharī‘ah principles that govern Islamic finance?

Prohibition of ambiguity in transactions (Gharar): ‘Gharar’ refers to elements in a contract that intend to deceive, cheat and cause uncertainty. In order to protect the rights of parties engaging in a contract, Sharī‘ah forbids any sale transaction contract that contains elements which are uncertain and ambiguous and may ultimately lead to dispute between the contracting parties.

Prohibition of gambling and excessive speculation (Maysir): Maysir or speculation refers to actions whereby an individual engages in excessive risk taking and expects a windfall gain based on chance. This is similar to gambling whereby no productive activity is involved and a person makes gains at the expense of others. There is merely a transfer of wealth from one party to another without any counter value involved. This is considered to be immoral and does not benefit the society.

Prohibition of dealing with harmful commodities: One of the aims of the Sharī‘ah is to promote a society whereby people are of sound mind, sound body and sound morals. Anything which is potentially harmful to the society is to be avoided. Examples are intoxicants, alcohol, pornography and weapons among others.

What are the main features of Islamic finance as derived from the Sharī'ah Principles?

Sharī'ah principles have been translated into four main pillars deemed to be the main features of Islamic finance. Together, they promote sustainability, look after the interest of all stakeholders as well as the end result of all transactions.

Sharī'ah Principles Consistent with Universal Values

Asset Backed	• Transactions are supported by real assets and services • Contributes directly to the growth of the real economy • Promotes financial stability • Contributes to sustainable development
Ethical	• Avoidance of unethical and immoral activities • Avoidance of interest-based transactions • Avoidance of gambling and excessive speculation • Promotes equity, justice and fairness
Participative	• Equity based and risk sharing transactions • Transparency regarding risks and profit sharing • Transactions based on different contractual relationships • Promotes entrepreneurship
Good Governance	• Avoidance of uncertainty and ambiguity in contracts • Promotes greater transparency and disclosure • Leads to accountability and responsibility • Promotes the well-being of the society

Why do these principles matter?

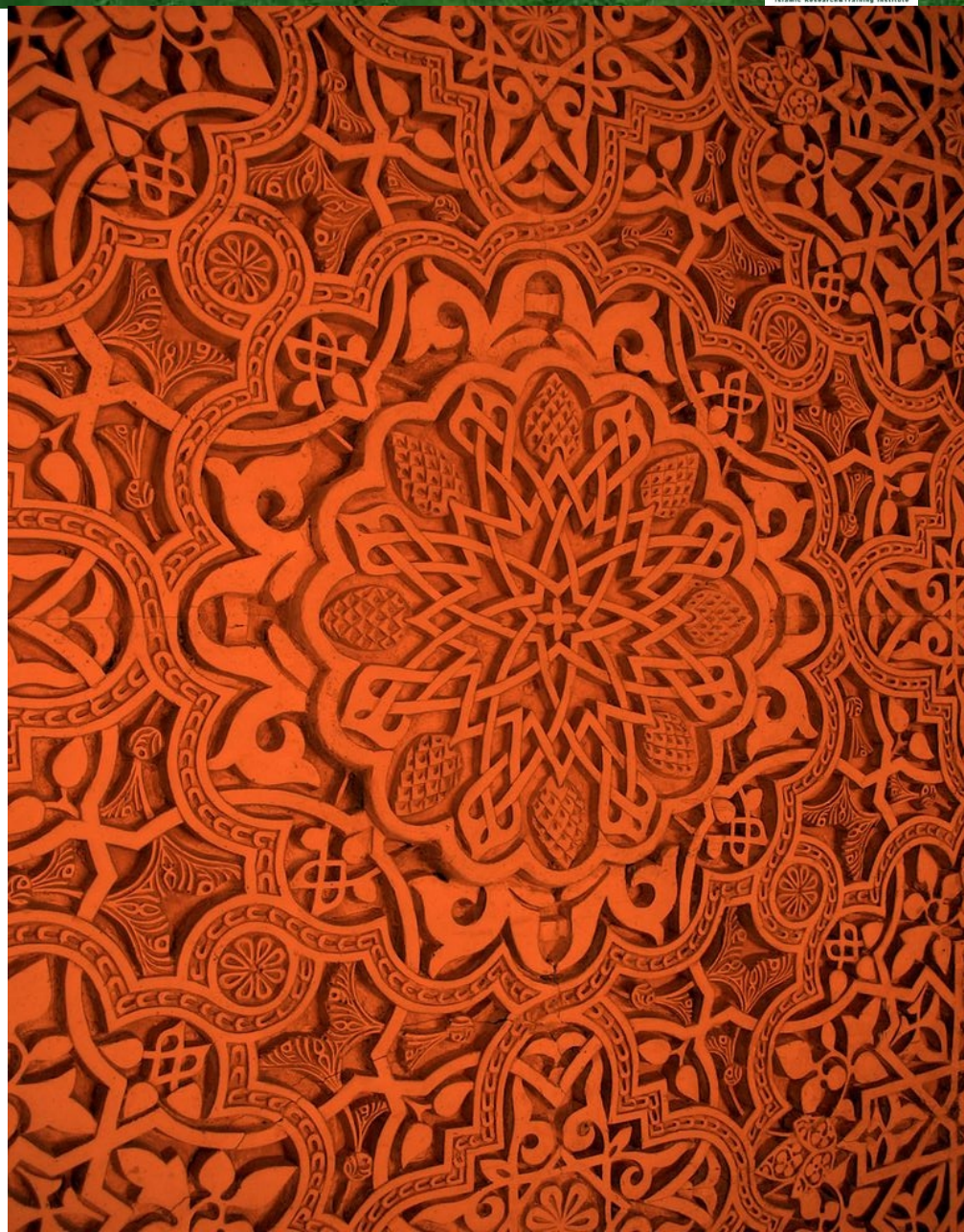
The lack of a moral compass and value-based framework in our dealings and transactions has contributed to events that have jeopardized the sustainability of our societies and the environment. Among them we note:

- An increasing gap between the rich and the poor
- Increasing household debt
- Global financial meltdown
- Accelerating climate change
- Increasing insecurity and moral decadence

These should compel us to reconsider how our actions impact our society, our people, the world around us and future generations.

The principles espoused by Islamic finance aim to contribute towards a sustainable society that is based on strong economic fundamentals and moral values. Adopting these principles is the first step in changing the way business gets done and in creating a more sustainable world.

Contracts in Islamic Finance



What is the importance of contracts in Islamic finance?

Islam places great importance on the sanctity of contracts and encourages all parties in a contract to write down the terms, conditions, rights and responsibilities to avoid potential disputes.

A person's property in Islam is sacred and inviolable. Islam has laid down guidelines to protect parties entering into a contract, and explicitly forbids the unlawful taking of other people's property by way of fraud, theft or deceit.

These prohibitions provide added protection to parties entering into a contract and complement the prohibitions of Ribā (interest), Gharar (uncertainty), and Maysir (gambling), which are all considered wrongful means of appropriating wealth.

What are the main contracts in Islamic Finance?

The main contracts used in Islamic finance can largely be split into three broad categories, namely transactional, equity and support contracts.

Main Contracts in Islamic Finance

Transactional Contracts	Equity Contracts	Support Contracts
Murābaḥah (Cost Plus Sale)	***Muḍārabah*** (Trust - Partnership)	***Wakālah*** (Agency)
Bai Muajjal (Deferred Payment Sale)	***Mushārakah*** (Joint Venture)	***Wadī'ah*** (Custody)
Ījārah (Leasing)	***Muzāra'ah*** (Output Sharing)	
Istiṣnā' (Manufacture-Sale)		
Salam (Deferred Delivery Sale)		

Murābaḥah

It is a kind of sale where the seller expressly mentions the cost incurred on the commodity being sold to the buyer and informs the buyer of the margin of profit being earned on the sale.

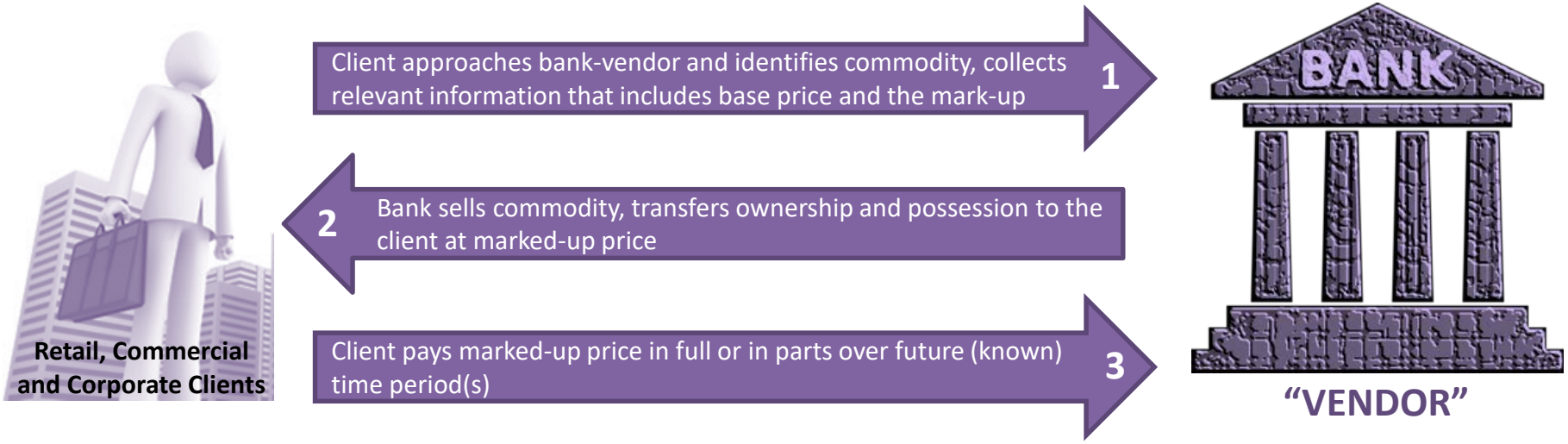
Client: I would like you to know the following about this commodity

Cost of Product	US$ 1,000
Profit	US$ 100
Murābaḥah Price	US$ 1,100
Payment Due	3 months later

The simplest possible structure emerges when the transaction involves two parties only – the client and bank. The bank is also the vendor and sells the commodity to its client on a deferred payment basis.

Murābaḥah Financing Structure 1 (One Contract)

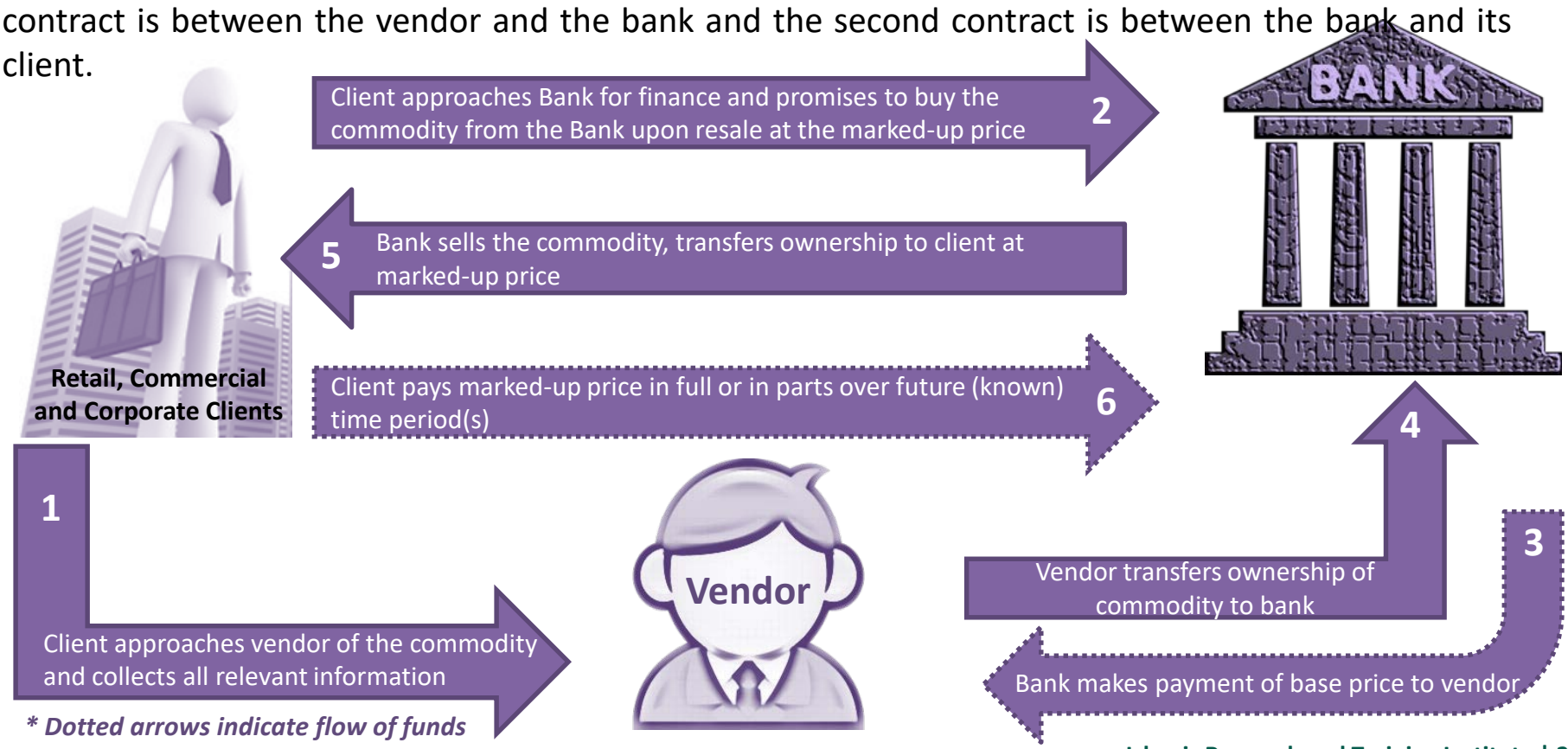
Murābaḥah is a sale contract in which the seller expressly mentions the cost he has incurred on the commodity being sold to the buyer and informs the buyer on the margin of profit he is earning on the sale. When payment of price is deferred to a future date, such credit sale is called Bai Muajjal.



This structure is being used in car financing products. The bank in this case claims to have its own car showrooms from where its clients may purchase cars on a deferred payment basis. This financing structure can be used for the financing of many different kinds of assets.

Murābaḥah Financing Structure 2 (Two Contracts)*

Client is in need of a commodity/asset and approaches a bank. Later, the bank buys the commodity from the vendor/supplier at price P. The client also knows this price. Next, the bank sells the commodity to the client at a marked-up price, say P+M, where M is the agreed profit or mark-up taken by the bank. The payment of price P+M is now deferred to a future date and is made in full or in parts. Hence, there are two distinct sale contracts that occur at different points of time. The first contract is between the vendor and the bank and the second contract is between the bank and its client.



** Dotted arrows indicate flow of funds*

Murābaḥah Financing Structure 3 (Client as an Agent)

In this structure, the bank does not directly deal with the vendor regarding the first purchase of the commodity. The bank here appoints the client as its agent. The client in this capacity would deal with the vendor as far as the first purchase of the commodity is concerned.

1	There is an agreement between bank and client whereby the bank promises to sell and the client promises to buy the commodity at the marked-up price. The promise covers agreed profit to be added to the cost, which is already known to the client, and fixed date(s) of repayment	4	Vendor makes physical delivery of commodity to agent (client) of bank; trained staff from bank oversee the process of client taking physical possession of goods
2	Bank appoints client as its agent	6	The agency contract comes to an end. Bank sells the commodity on the basis of the initial agreement, transfers ownership to client at marked-up price
3	Client identifies the vendor, selects the goods on behalf of the bank and provides all relevant information on the goods, vendor and purchase price to the bank in writing	7	Client pays marked-up price in full or in parts over future (known) time period(s)

** Dotted arrows indicate flow of funds*

Ijārah

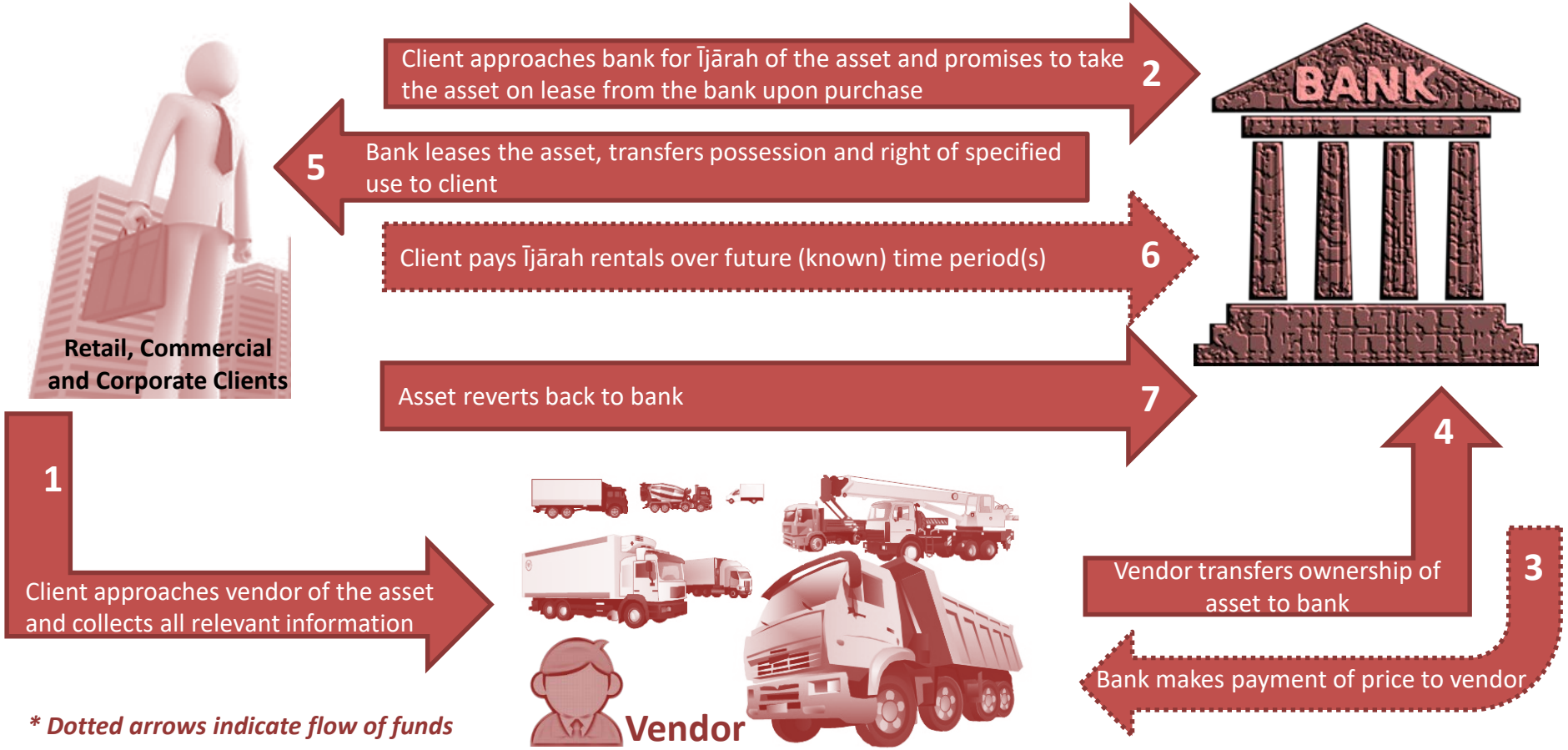
It is the sale of the right to use a particular product or commodity or service. It is a leasing type of contract where the usufruct of a particular property is transferred to another person in exchange for a regular rental payment until the end of the contract.

"You can use this computer for 12 months in exchange for a monthly rental payment of US$100"

Ījārah, like Murābaḥah, is a fund-based business for the Islamic bank. In both cases, the bank is not a natural owner of the asset (sold under Murābaḥah or given in lease under Ījārah.) It acquires ownership upon receiving a request from its client. Similar to Murābaḥah, the Ījārah rentals are also paid in installments over time, and cover the cost of the asset or value of investment for the bank and to provide a fair return on investment. Both Murābaḥah and Ījārah are contracts that create debt.

Ījārah Financing Structure 1 (Through Vendor)

In this structure, there are two distinct phases. In phase one, the bank purchases the asset needed by its client from the vendor. In phase two, the bank, as owner of the asset, leases out the same to its client against predetermined rentals for an agreed period of time.



** Dotted arrows indicate flow of funds*

Ījārah Financing Structure 2 (Through Bank)

The bank does not deal directly with the vendor in connection with the first purchase of the commodity. It appoints the client as its agent. During the first stage, the client cannot be held liable for the obligations of a lessee. In this period he is responsible to carry out the functions of an agent only. But when the asset is delivered to him, he is liable to discharge his obligations as a lessee.

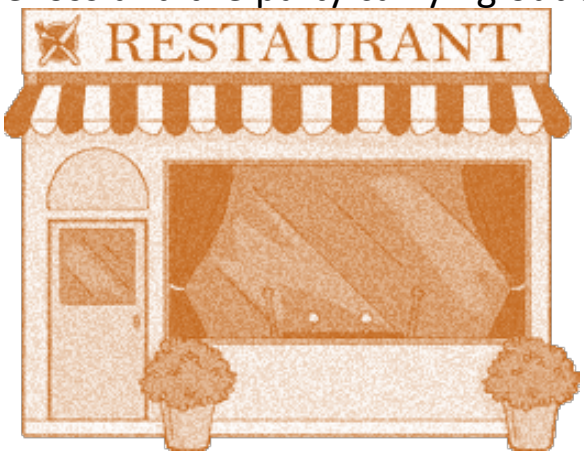
1	There is an agreement between bank and client whereby the bank promises to lease and the client promises to take on lease the asset against predetermined rentals for a definite time period	5	Bank makes arrangement for payment of purchase price to vendor
2	Bank appoints client as its agent	6	The agency contract comes to an end; bank leases the asset on the basis of the agreement, transfers possession and right of specified use to client
3	Client identifies the vendor, selects the asset on behalf of the bank and provides all relevant information on the vendor, asset and purchase price to the bank in writing	7	Client pays known rentals over future (known) time period(s)
4	Vendor makes physical delivery of asset to agent (client) of bank; trained staff from bank oversee the process of client taking physical possession of asset	8	Asset reverts back to bank

** Dotted arrows indicate flow of funds*

Muḍārabah

It is a form of partnership between two parties where one party has the expertise to carry out an investment and the other party has the money (the investor). Profits are shared as per a pre-agreed ratio between the two parties. In case of loss, the investor bears the loss and the party carrying out the investment does not earn any profit.

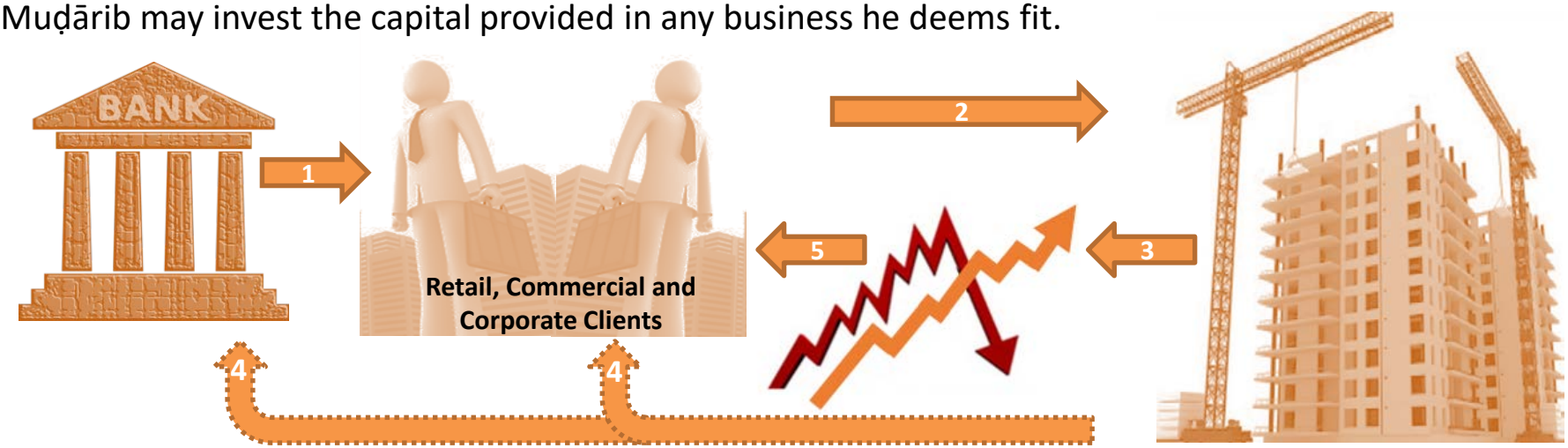
”I hereby provide you with US$100,000 to open a restaurant business. My share of any profit which the business produces shall stand at 70%.”



It is a mode of financing through which the bank provides capital finance for a specific venture indicated by the customer. The bank, called Rabb al-māl, is the owner of the capital and the client-entrepreneur, called Muḍārib, is responsible for the management of the business and provides professional, managerial and technical expertise for initiating and operating the business. Profit is shared according to a pre-agreed ratio. Losses, if any, are entirely borne by the capital provider – the bank.

Muḍārabah Financing Structure (Trustee Partnership)

Muḍārabah may be of two types – restricted or unrestricted. In a restricted Muḍārabah (Muḍārabah al-muqayyada) the bank or the financier may specify a particular business in which investments may be undertaken. Muḍārabah may also be an unrestricted one (Muḍārabah al-mutlaqa); in which case the Muḍārib may invest the capital provided in any business he deems fit.

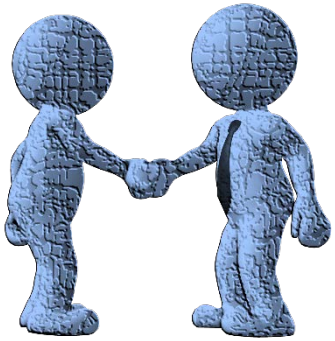


1	Bank and client discuss business plan; bank provides funds to client towards capital investment	5	Business generates positive or negative profits
		6	Profits are shared between client and bank as per a pre-agreed ratio
2	Client sets up the business and manages its operations	7	Losses are absorbed by bank; effectively bringing down the value of the asset created with its investments

** Dotted arrow indicates flow of funds*

Mushārakah

It refers to an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital and share managerial responsibilities as a general rule. The profit of the enterprise is shared among the partners in agreed proportions while the loss will have to be shared in strict proportion of capital contributions.

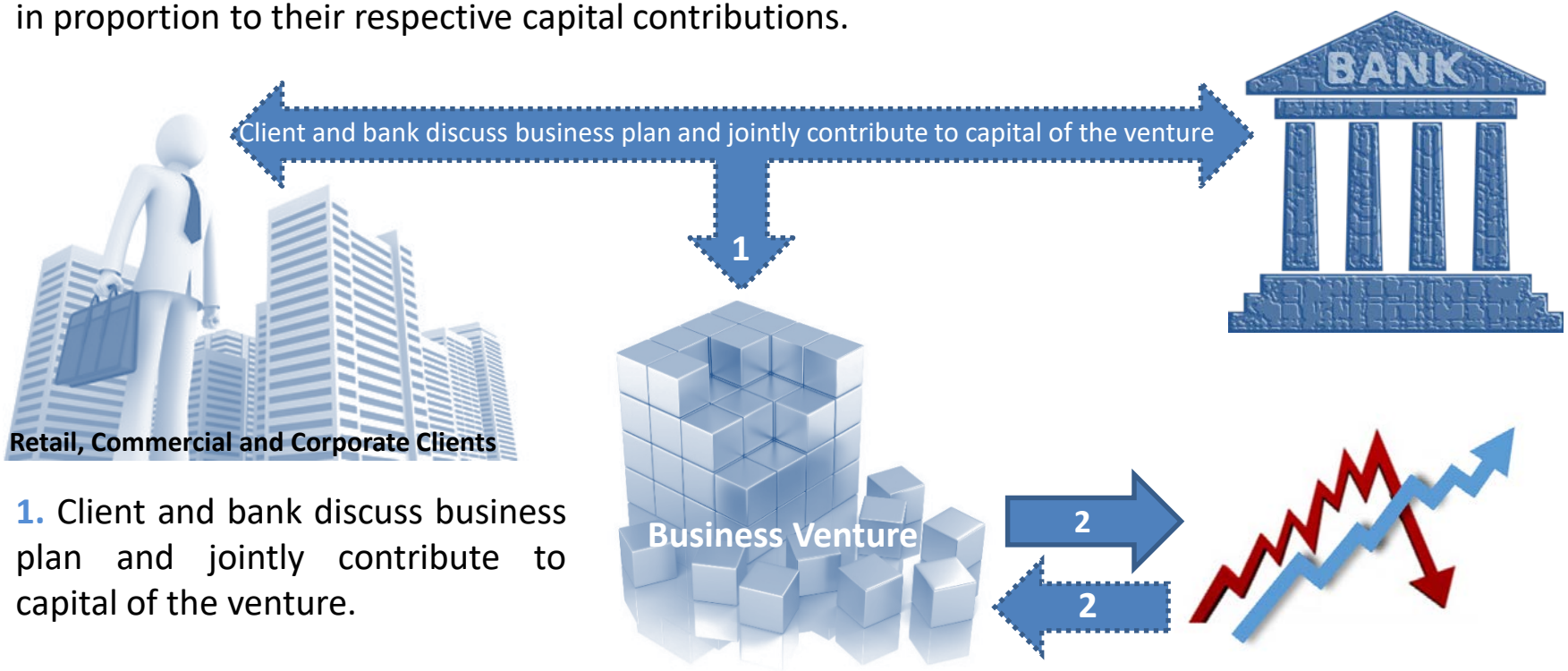


"I am pleased to enter into a Mushārakah agreement with you. We shall split profits at 55:45 and bear losses as per the capital we brought into the business."

A joint venture based on Mushārakah involves a partnership in which both the bank and its customer-client contribute to entrepreneurship and capital. It is an agreement whereby the customer and the bank agree to combine financial resources to undertake any type of business venture, and agree to manage the same according to the terms of the agreement.

Mushārakah Financing Structure (Joint Venture)

Profits are shared between the bank and the customer in the pre-agreed ratio. Losses are shared strictly in proportion to their respective capital contributions.



1. Client and bank discuss business plan and jointly contribute to capital of the venture.

2. Profits are shared as per a pre-agreed ratio. Losses are shared in proportion to capital contributions, effectively bringing down the asset value while keeping their respective shares in it unchanged.

** Dotted arrows indicate flow of funds*

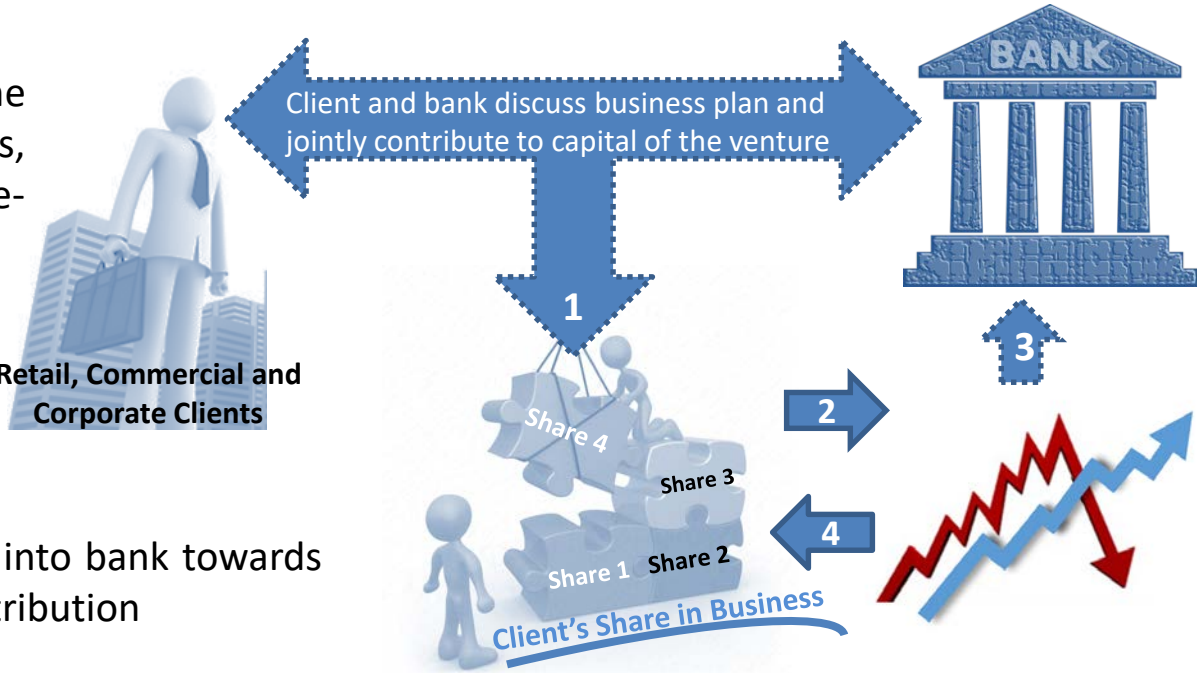
Declining Mushārakah Financing Structure

Its popularity originates from the fact that classical Mushārakah aims to involve bank as a permanent partner in the venture. In a declining Mushārakah, the bank's share in the equity is diminished each year through partial return of capital. The bank receives periodic profits based on its reduced equity share that remains invested during the period. The share of the client in the capital steadily increases over time, ultimately resulting in complete ownership of the venture.

1. Client and bank jointly set up the venture and manage its operations, sharing responsibilities as per pre-agreed terms

2. Profits are shared between client and bank as per a pre-agreed ratio

3. The profit share of client flows into bank towards acquiring of the bank's capital contribution



4. Losses are shared between client and bank in proportion to their respective capital contributions; effectively bringing down the asset value while keeping their respective shares in it unchanged

** Dotted arrows indicate flow of funds*

Istiṣnā‘

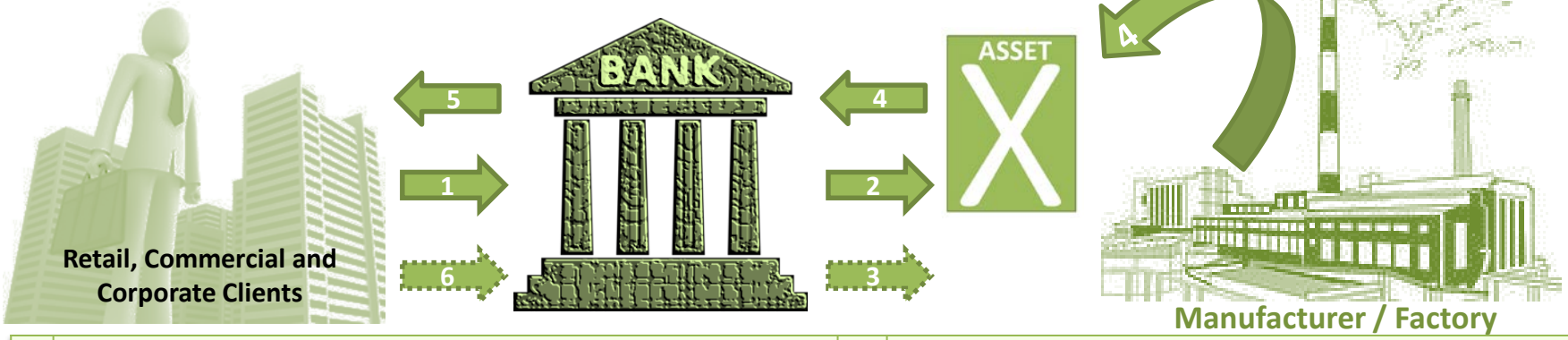
It is a contract of manufacturing. A seller under an Istiṣnā‘ agreement undertakes to develop/manufacture a commodity with clear specifications for an agreed price to deliver after an agreed period of time. The unique feature of Istisna’ is that nothing is exchanged at the time of contracting. It is perhaps the only forward contract where the obligations of both parties relate to the future. The buyer makes payment in parts over the agreed time period or in full at the end of the time period.

”As per our Istisna’ contract, your residential compound has been built within the specified period of 12 months. We are happy to deliver same to you.”

In an Istisna’, the seller and the manufacturer may be different entities. This allows financiers or intermediaries like Islamic banks to engage in Istisna’ by assigning the job of development, manufacture or construction to a third party under a parallel Istisna’ arrangement. Istisna thus, is now transformed into a financing product. The difference between the price received from the client and the price paid to the manufacturer constitutes profit for the bank. Istisna’ facility is suitable for commercial or residential buildings, industries, roads, aircraft, vessels, etc.

Istiṣnā‘ Financing Structure (Manufacture-Sale Facility)

Istiṣnā‘ involves various construction-related risks and risk of non-conformity to specifications. In order to mitigate such risks the agreement may contain a penalty clause. Another alternative for the bank is to nominate the client as an agent to oversee satisfactory completion of the job. Like other financing mechanisms, Istiṣnā‘ involves risk of default and delinquencies and a bank can take various measures such as lien on land on which the asset is being built, any other property or personal or third party guarantee to mitigate such risk.

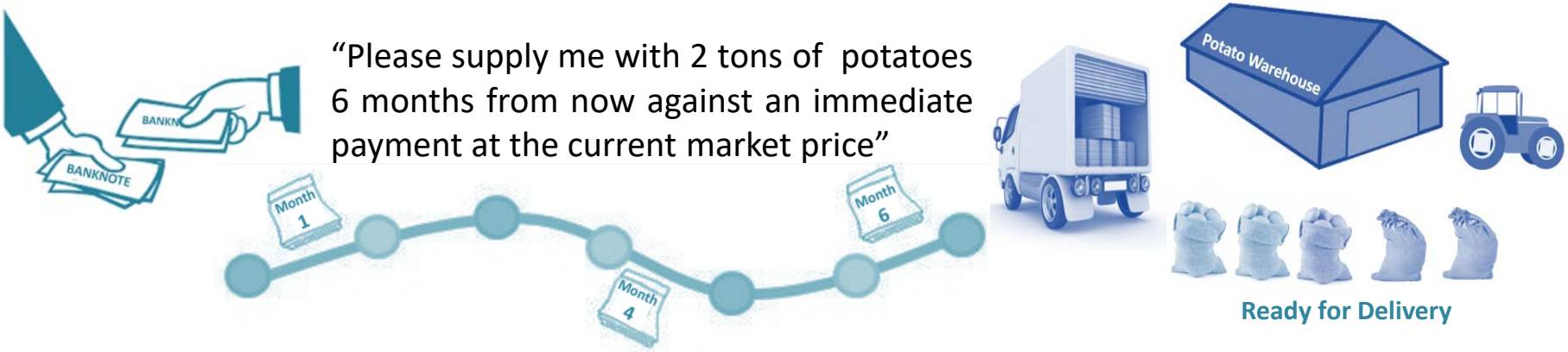


1	Client asks bank to develop, construct or manufacture asset X with clear specifications	4	Manufacturer gives delivery of asset to bank
2	Bank asks manufacturer to develop, construct or manufacture asset X with same specifications	5	Bank gives delivery of asset to client
3	Manufacturer develops, constructs or manufactures asset X, receives progress payments from bank as per agreed terms during different stages of manufacturing	6	Client pays in full or in parts over agreed period of time

** Dotted arrows indicate flow of funds*

Salam

It is a deferred delivery contract. It is essentially a forward agreement where delivery occurs at a future date in exchange for spot payment of price. Unlike earlier mechanisms of *Murābaḥah* and *Ījārah*, *Salam* is originally designed as a financing mechanism for farmers and traders.



"Please supply me with 2 tons of potatoes 6 months from now against an immediate payment at the current market price"

Under a Salam agreement, a trader in need of short-term funds sells merchandize to the bank on a deferred delivery basis. It receives full price of the merchandize on the spot that serves its financing need at present. At a pre-agreed future date, it delivers the merchandize to the bank. The bank sells the merchandize in the market at the prevailing price. Since the spot price that the bank pays is pegged lower than the expected future price, the transaction should result in a profit for the bank.

Salam Financing Structure 1 (Deferred Delivery Sale)

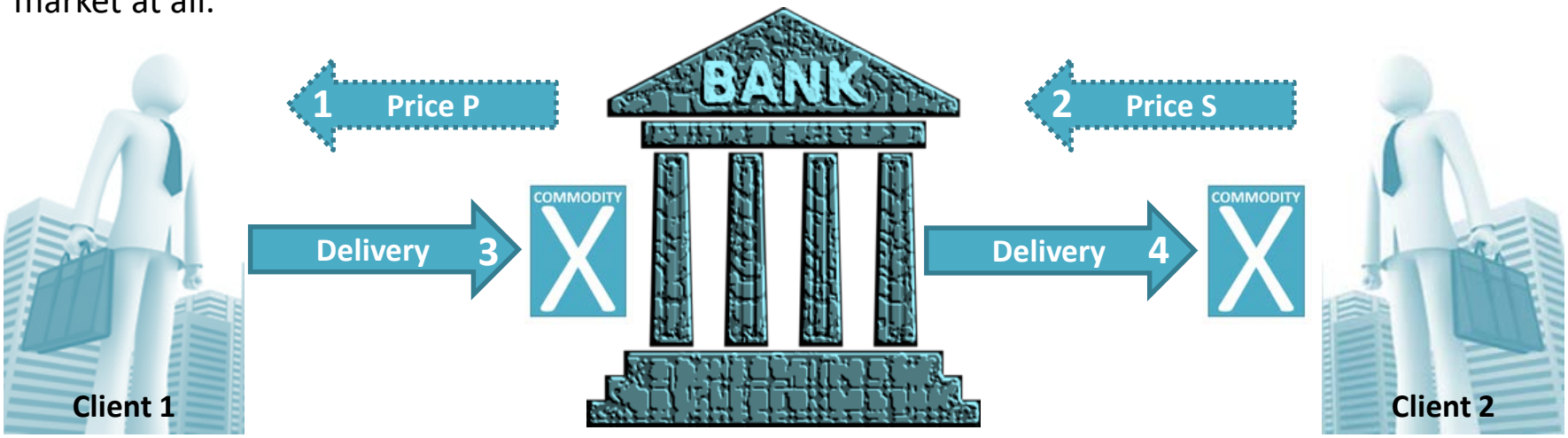
Since "selling what one does not have" is disapproved on grounds of Gharar, the following structure does not permit the bank to sell commodity X before taking delivery of the same. Thus, the bank would need to wait till time of actual delivery before it can get back its investment and profits. If the bank does not want to commit its funds for the given time period, it may enter into a parallel or back-to-back Salam contract with a third party (See the next structure).

3. Bank sells X in the market at time period t or later and realizes S. The amount S-P constitutes profit for the bank.

** Dotted arrow indicates flow of funds*

Salam Financing Structure 2 (Parallel Salam)

One of the main issues with the previous simplified structure is the price risk the bank is exposed to. It is quite possible that price of the commodity declines during time period t to a level below P resulting in losses to the bank. This risk is mitigated in a Parallel Salam, as the bank need not participate in the market at all.



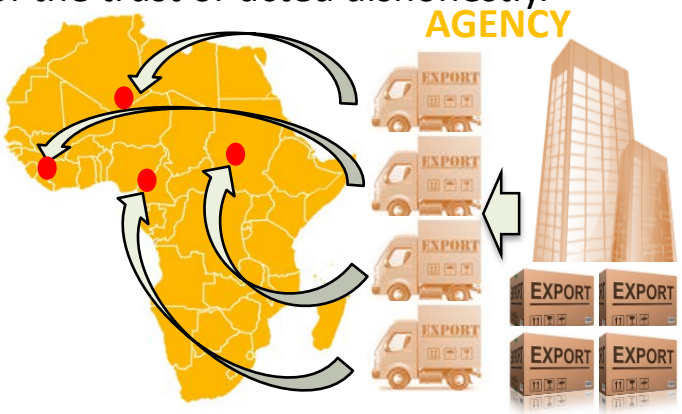
1	Client1 sells commodity X to bank on forward basis and receives price P in time period 0	3	At time period t, Client1 delivers X to bank
2	Bank sells commodity X to Client2 on forward basis and receives price S in time period 0	4	At time period t, bank delivers X to Client2. The amount S-P constitutes profit for the bank.

** Dotted arrows indicate flow of funds*

Wakālah

It is an agency contract whereby person A hires person B to act on his behalf. The agent is entitled to receive a pre-agreed fee irrespective of whether he is able to accomplish the assigned task to the satisfaction of the principal or not as long as he acts in a trustworthy manner. The agent would be liable to penalties only if it can be proved that he violated the terms of the trust or acted dishonestly.

”I hereby assign you to represent me for my export transactions in Africa. You shall be remunerated for your services as per our agreed terms.”



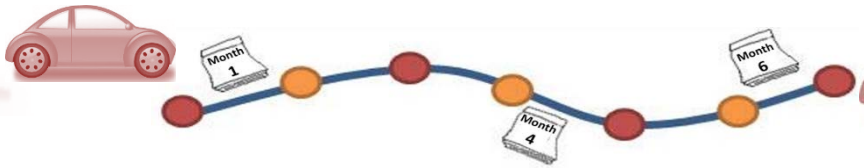
In the banking system, Wakālah is an Islamic money market concept used in deposit products. The depositors as Muwakkil place funds in the bank to invest in suitable Sharī‘ah projects. The bank acts as an agent to invest these funds into various assets and projects.

The bank as an agent is entitled to receive a fee for its services while the returns will be given to the depositors or investors.

Wadī‘ah

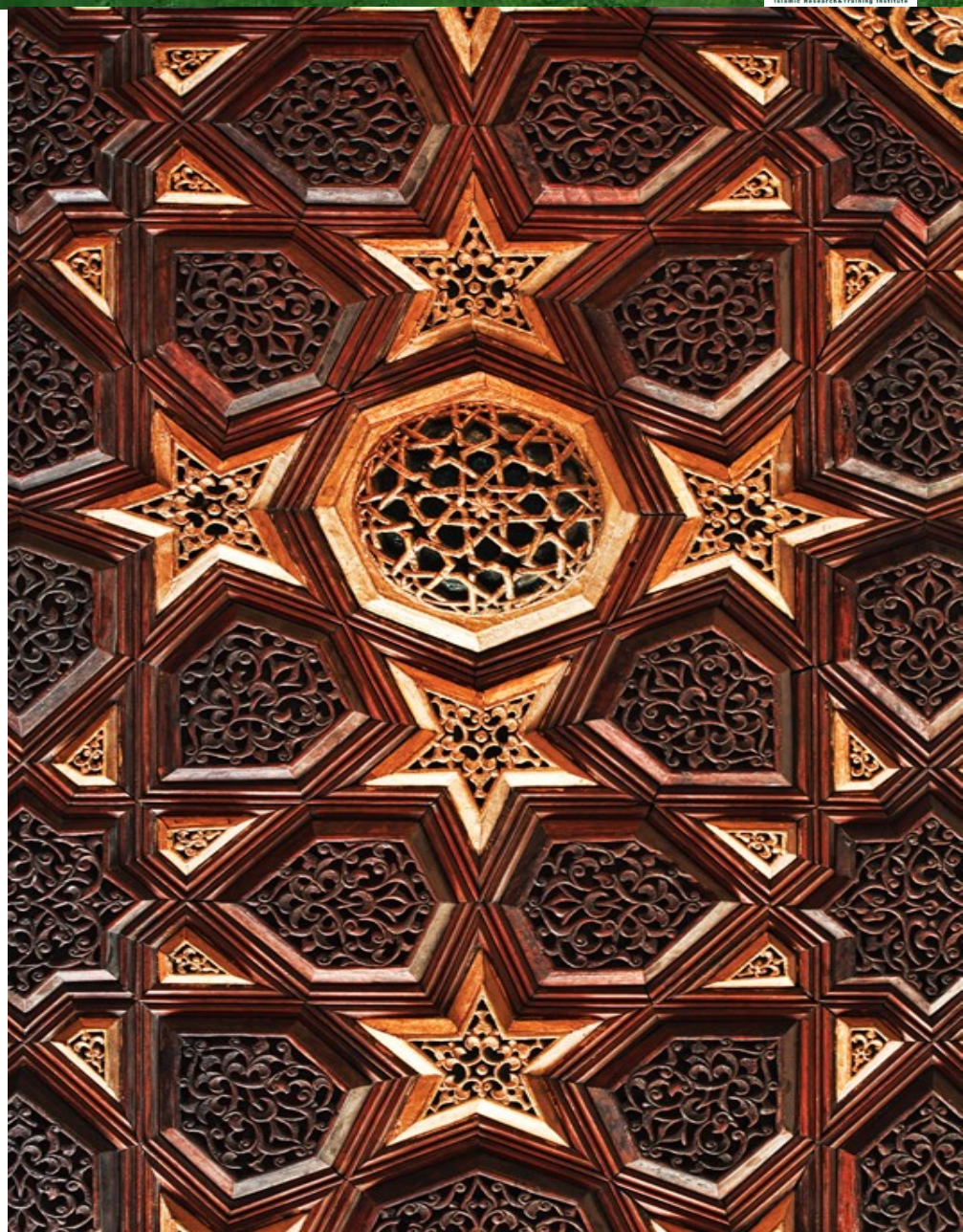
It is a custody agreement whereby one party, the trustee, agrees to hold an item or a deposit in trust for another person, the Trustor. If the Trustor pays for the services, the trustee has to replace the item if lost or damaged. Any usage of the item needs the approval of the Trustor.

"I would like you to keep my car in trust for six months in your **Autopark** parking garage as I will be going on vacation."



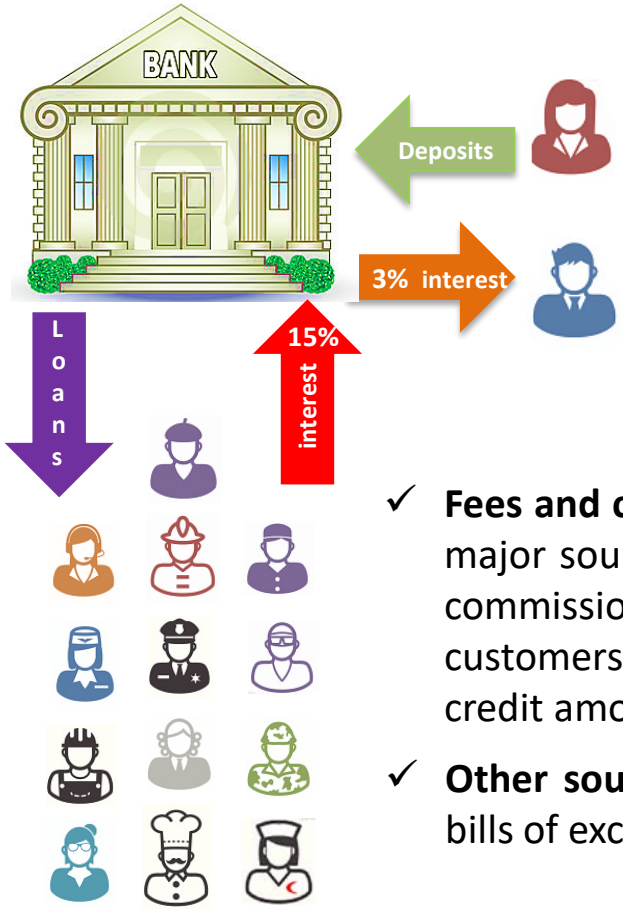
In the banking system, Wadī‘ah refers to a contract between the owner (depositor) of the goods (the money) and the custodian (bank) for safekeeping. The depositor grants the bank the permission to utilize the money for any kind of purpose permitted by Sharī‘ah. The bank in return guarantees the value of the deposit thus creating a Wadī‘ah Yad-Dhamanah contract.

Islamic Banking



What is a bank?

A bank is a profit seeking financial institution which deals in money and credit. It basically accepts deposits from customers for safekeeping and utilizes those deposits to provide loans to businesses and the public.



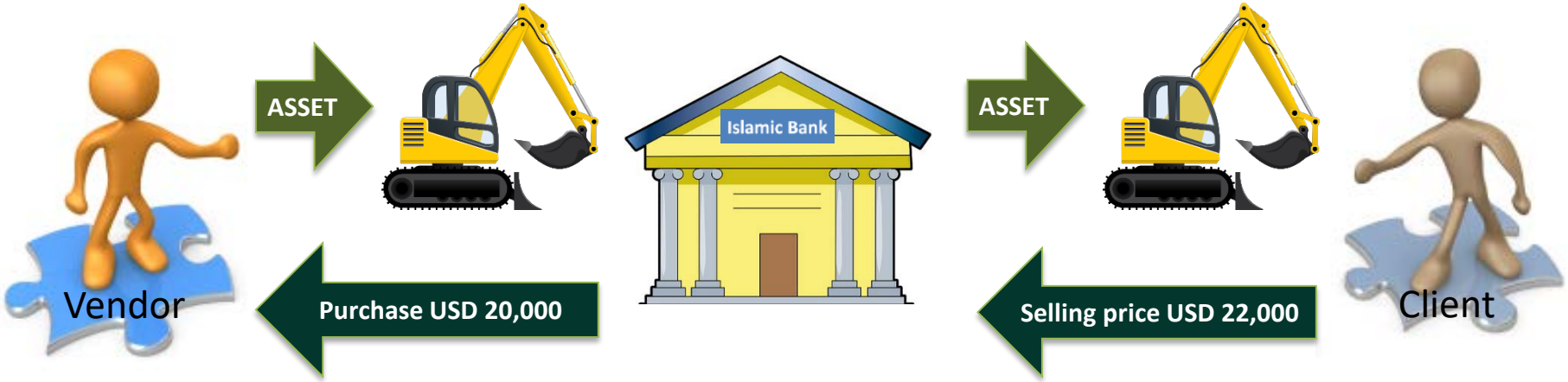
The bank derives its income from a number of ways:

- ✓ **Interest from loans:** A major portion of a bank's income comes from the spread it earns by borrowing money from depositors at a low interest rate and lending to businesses and the public at a higher interest rate. The bank does not actively share the risks of its business customers and is only exposed to relatively low credit risks given that the loans are backed by collaterals and guarantees.
- ✓ **Fees and commissions:** Fees and commissions are another major source of bank income. The bank charges fees and commissions for the numerous services it provides to its customers. Examples are cheques, direct debits, letters of credit among others.

- ✓ **Other sources:** The bank also earns income from interest on investments, bills of exchange, foreign exchange transactions among others.

What is an Islamic bank?

An Islamic bank is a financial institution which provides safekeeping facilities for its customers and engages in trading transactions, equity investments and leasing activities to make profit, while complying with the ethics and values laid down by the Sharī‘ah. Unlike the traditional bank, transactions with an Islamic bank do not involve interest and have to abide by strict ethical and moral considerations.

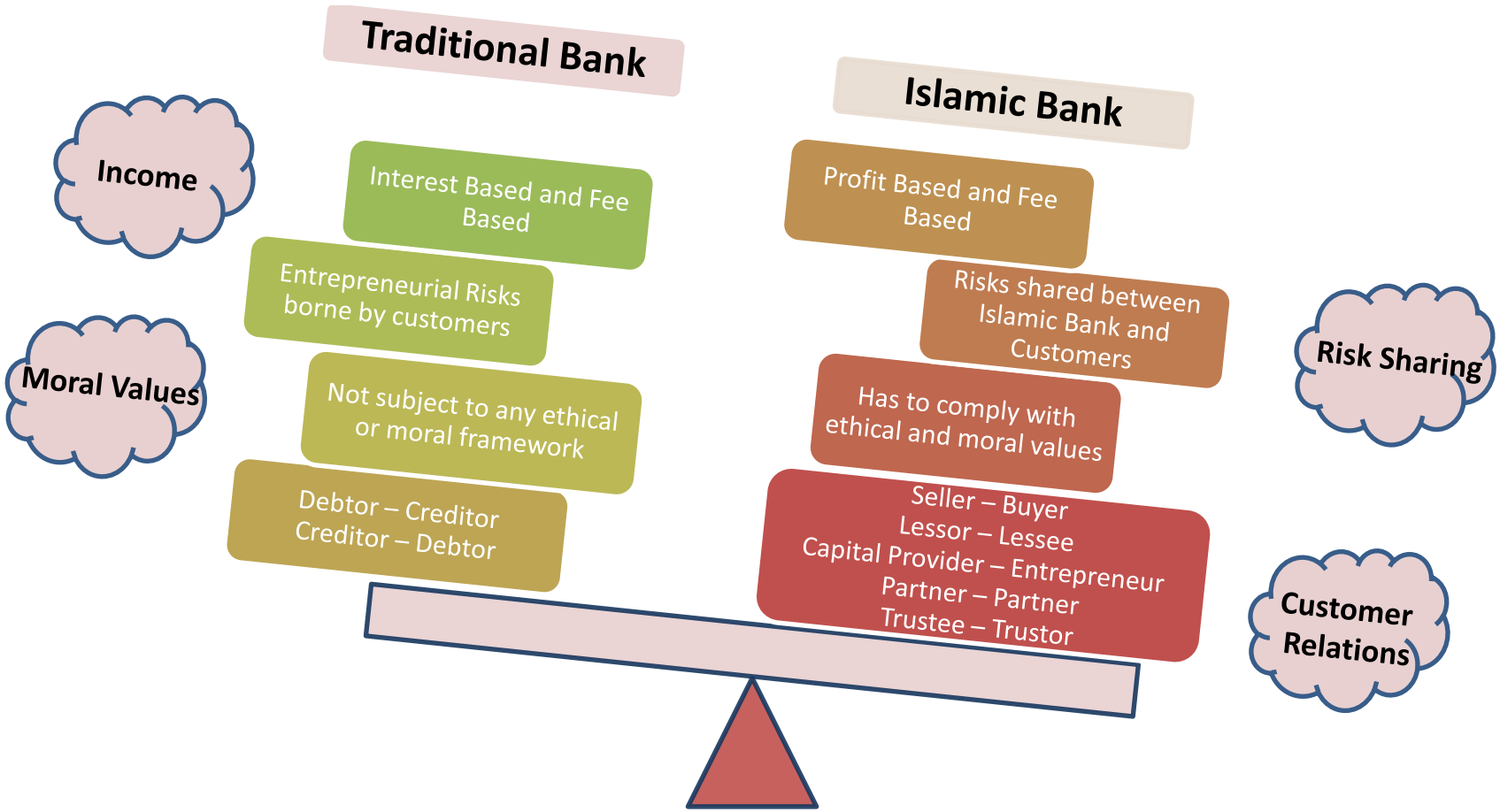


Customers depositing their money into an Islamic bank for safekeeping normally do so for a custodial fee and are not entitled to any predetermined return arising from the use of their deposits by the bank.

One of the ways which Islamic banks earn their income is through trading transactions, whereby the bank buys an asset at a price, say USD 20,000, from a vendor and after taking possession of the asset, sells the asset at a profit to customers.

What are the differences between a traditional bank and an Islamic bank?

The traditional bank and the Islamic bank operate on different business models and have different relationships with their customers. They are also guided by different motives and frameworks. These are illustrated below:

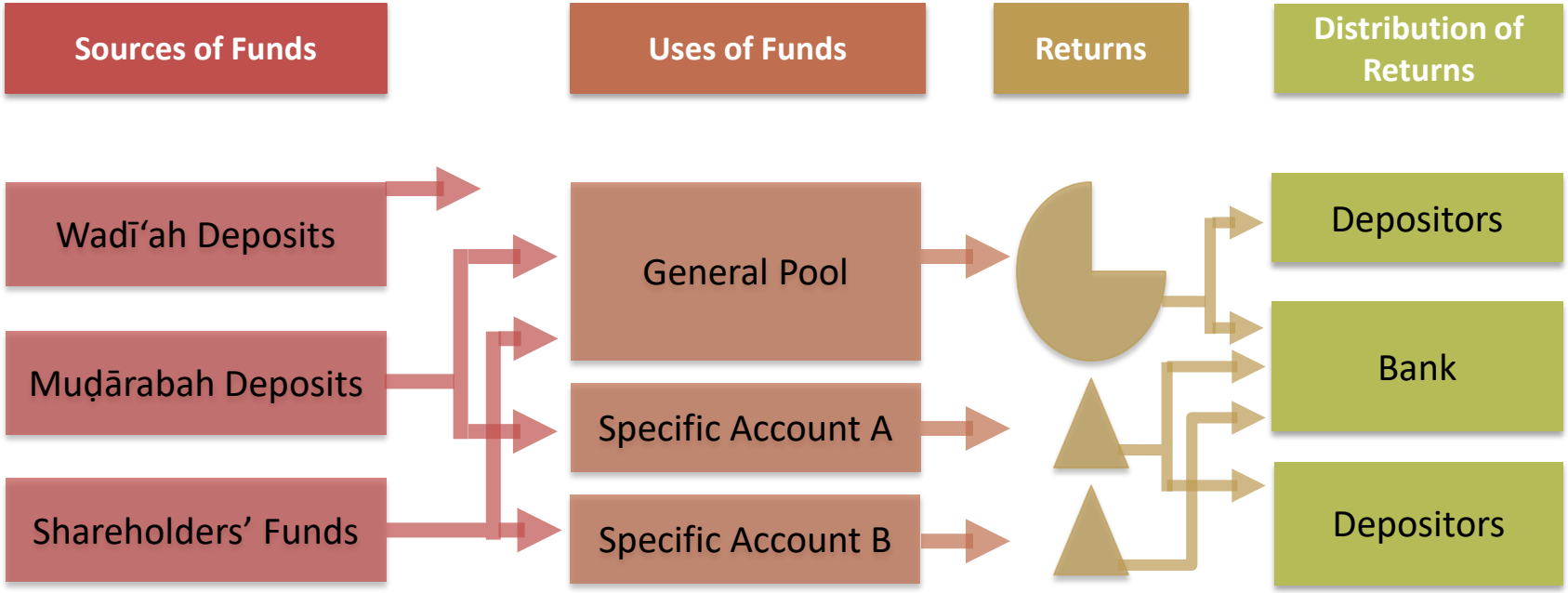


Islamic Banking Operations

What is the basic operational model for an Islamic bank?

The Islamic bank operates on a non-interest business model, which can be broken down into 3 segments as follows:

1. Sources of Funds
2. Uses of Funds
3. Distribution of Returns



How does the Islamic bank earn profit?

The Islamic bank derives its funding from deposits and equity and makes use of the funds to engage in trade, leasing, and investment activities. It derives its profit from the mark up it charges during those activities and from fee-based services.

The balance sheet below provides an overview of the sources and uses of funds of an Islamic bank.

Uses of Funds

- Cash
- Murābaḥah, Salam, Istiṣnā‘, Ījārah
- Muḍārabah, Mushārakah
- Fee-Based Services
- Non-Banking Assets

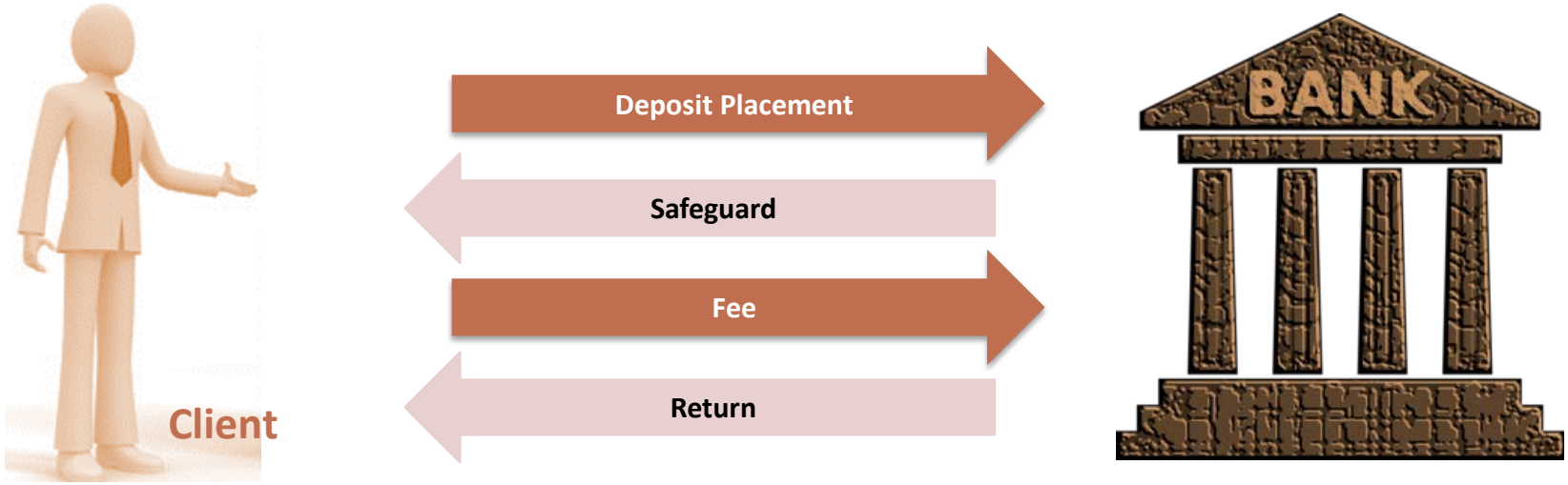
Sources of Funds

- Wadī‘ah Deposits
- Wakālah Deposits
- Muḍārabah Deposits
- Investment Sukuk / Reserves
- Equity

Illustration of Wadī‘ah deposit

1. Customer places money as deposit under a Wadī‘ah deposit account for a definite period.

2. The Islamic bank, as trustee, safeguards the deposit and guarantees its return.



3. The Islamic bank may charge a fee for accepting to safeguard the deposit.

4. At its own discretion, the Islamic bank may offer a gift to the customer as a reward for their loyalty.

Illustration of Muḍārabah investment

1. Customer places money in Muḍārabah deposit account

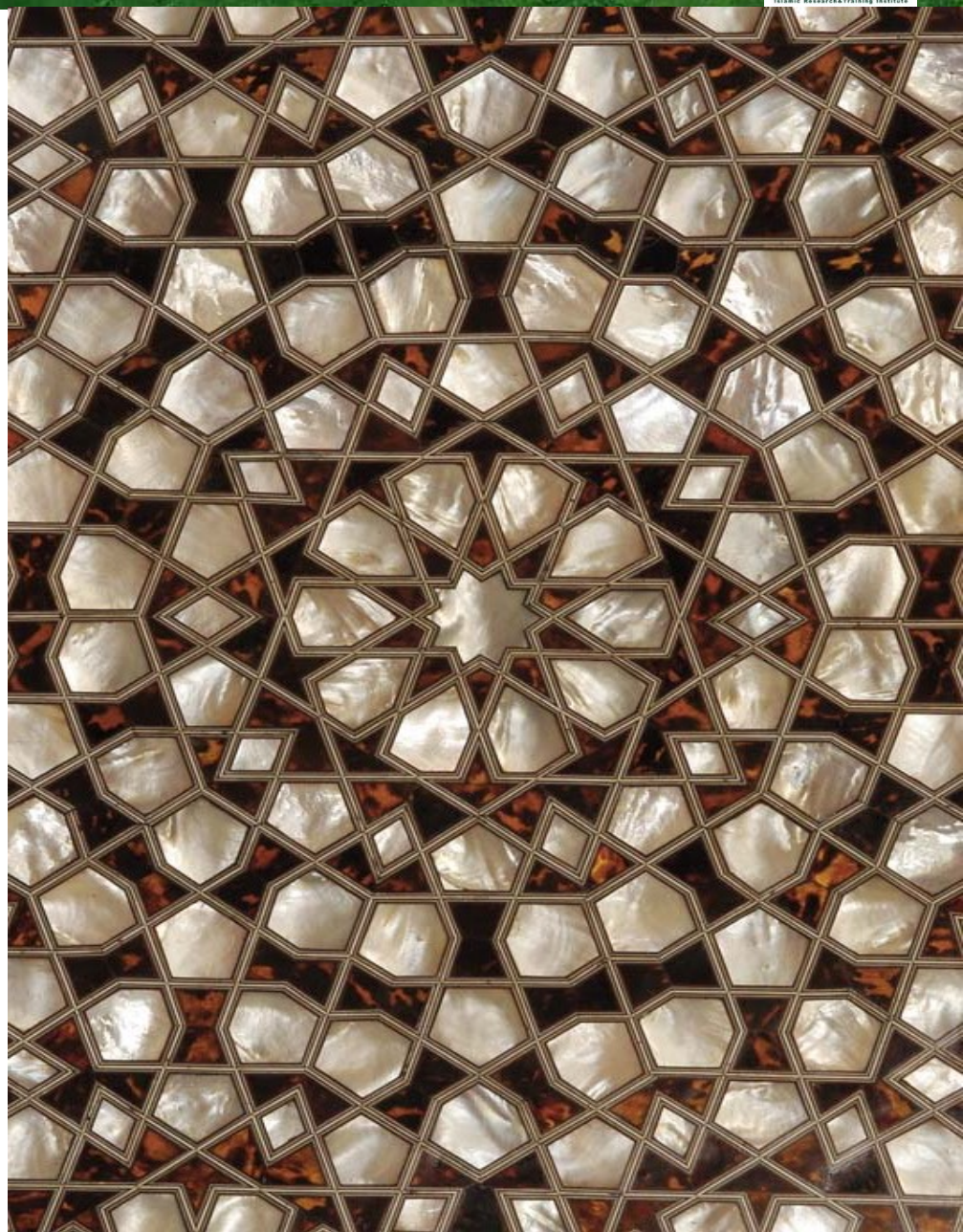
2. The Islamic bank invests the money in assets or projects

3. Depending on the cash flows generated by the project, the investment may or may not be profitable

4. Profit is shared between the bank and the customer based on a pre-agreed profit sharing ratio

5. Losses are borne by the customer, except in cases when there is proven negligence by the bank

Islamic Capital Markets



What are Islamic capital markets?

Islamic capital markets are platforms which allow resources to be mobilized in an efficient manner by allowing people, entities, and governments with surplus funds to transfer them to other people, entities and governments who need funds.

Islamic capital markets play a key role in the Islamic financial system in that they provide an alternative to parties who are interested in raising funds in a Sharī‘ah-compliant way.

What are the key components of Islamic capital markets?

The key components of Islamic capital markets are:

1. **Islamic Equity Markets**
2. **Sukuk Markets**

Islamic equity markets

Islamic equity markets deal with Sharī'ah-compliant stocks and related instruments. They allow companies to raise equity financing through the issuance of common stocks. Investors earn returns based on the earnings of the underlying business and share its risks.

Islamic equity markets consist of:

Islamic Unit Trusts

These are collective investment schemes that allows investors with similar objectives to pool their funds and invest in a single portfolio of securities. They invest in Sharī'ah-compliant stocks, instruments and assets.

Islamic Exchange Traded Funds (I-ETFs)

I-ETFs are collective investment schemes that are passively managed and invest in a portfolio that closely tracks an underlying Sharī'ah-compliant stock index. Buying a unit from the ETF provides investors exposure to a basket of different stocks.

Islamic Real Estate Investment Trusts (I-REITs)

I-REITs are essentially collective investment schemes where investors pool money together to purchase property for rental purposes and capital gain. The Islamic REIT invests in residential properties, offices and hospitals etc. and requires that tenants' activities are Sharī'ah compliant.

Sukuk markets

Sukuk markets are one of the fastest growing segments of the Islamic financial industry. Sukuk, the plural of the Arabic word 'Sakk', basically refers to investment certificates which are linked to an underlying asset. Through a Sukuk issuance, governments or entities are able to raise Sharī'ah-compliant external capital by allowing investors to take an ownership interest in a specified underlying asset and earn income from the cash flows generated by the underlying asset.

What are the main differences between a Sukuk and a bond?

	SUKUK	BONDS
Contract	Various underlying contracts	Lending-borrowing contract
Tenor	Short and mid-term	Short, mid and long term
Nature of Financing	Ownership in assets & their cash flows	Debt
Underlying Asset	Required	Not required
Recourse	To the obligations of the contract	To issuer
Returns	Dependent on the cash flows	Fixed in time and amount
Use of the Financing	Only in Sharī'ah-compliant assets	No restriction

Underlying contracts for Sukuk

Lease (Ījārah)
- Underlying Assets: Building, Land, Machinery, Property
- Returns: Lease Payments

Partnership (Musharakah)
- Underlying Assets: Services, Businesses etc
- Returns: Profit and Loss sharing

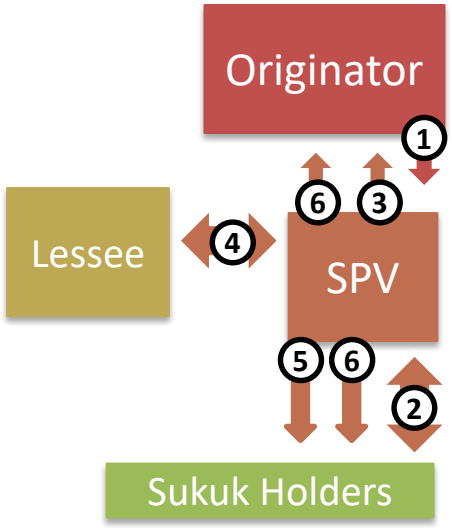
Investment (Muḍārabah)
- Underlying Assets: Projects, Services etc
- Returns: Profit and Loss sharing

Build Order (Istiṣnā')
- Underlying Assets: Roadways, Power plants etc
- Returns: Contractual profit

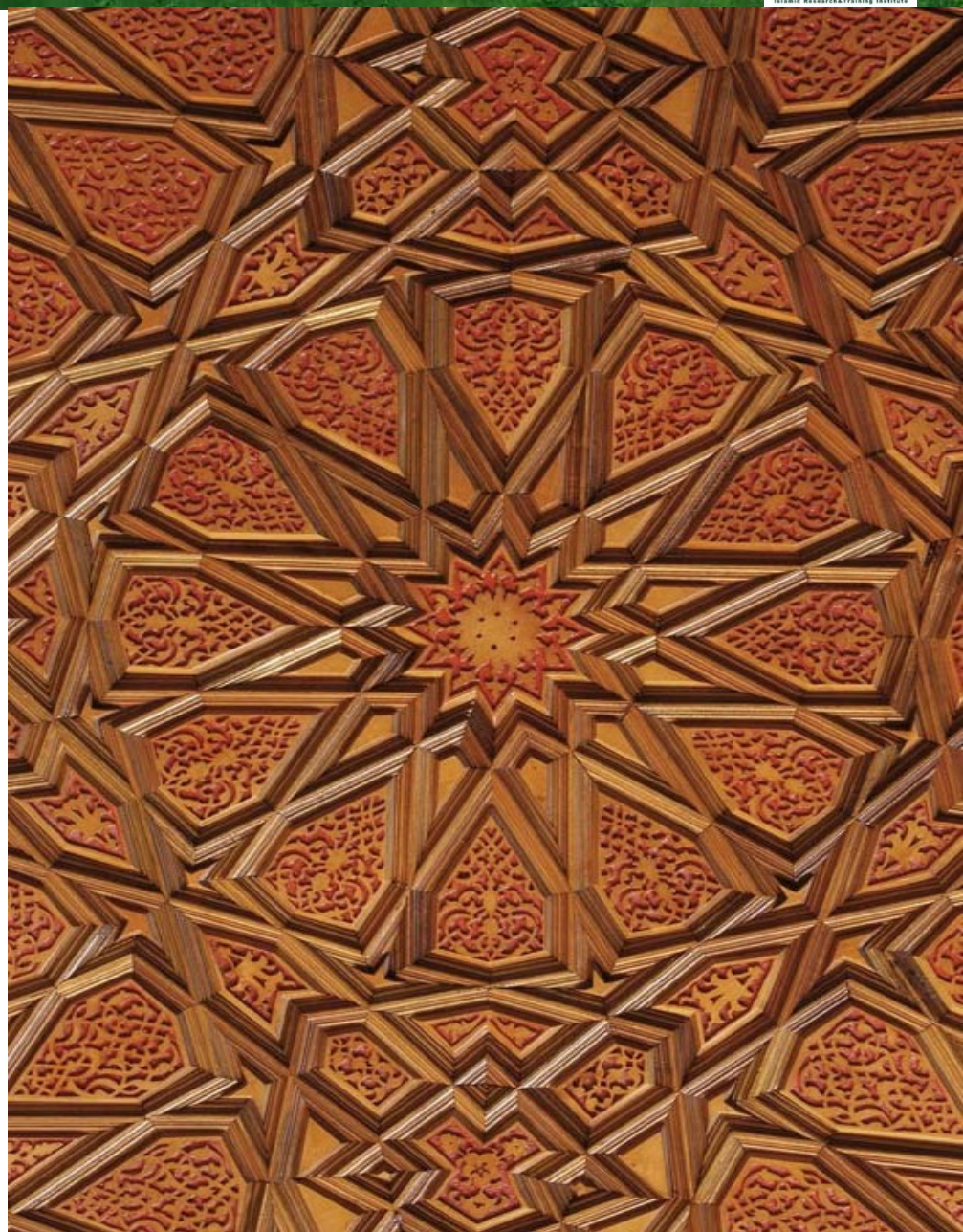
Agency (Wakālah)
- Underlying Assets: Services, Businesses etc
- Returns: Return on Investment

Illustration of an Ījārah Sukuk

1. Originator sells asset to SPV (Special Purpose Vehicle)
2. SPV issues Sukuk certificates to investors (Sukuk Holders) in exchange for capital
3. The SPV uses the proceeds to pay the Originator for the asset
4. The SPV offers an Ījārah contract to the Lessee and leases the asset in exchange for rent
5. The SPV passes on the net amount of the rent to the Sukuk Holders
6. At the end of the Lease agreement, the asset is sold (normally back to the Originator) and the proceeds of the sale are distributed to Sukuk Holders as repayment of their investment



Islamic Money Market



What are Islamic money markets?

Islamic money markets provide a channel for Islamic banks and other Sharī‘ah-compliant institutions to manage their liquidity. The liquidity of a bank represents a bank’s ability to meet anticipated demand for its funds from depositors and borrowers.

The Islamic money markets provide a mechanism through which holders of temporary cash surpluses meet holders of temporary cash deficits. The instruments used in the exchange normally have a maturity life of less than a year.

Islamic Money Markets

Commodity Murābaḥah

- Is designed to facilitate cash advances to a customer who needs cash to pay for various needs
- Banks sell to the customer commodities on deferred payment basis
- Subsequently the customer sells these commodities on spot basis to receive cash
- Customer is not interested in utilizing the purchased asset or benefiting from it as a commodity rather he approaches it as a means to facilitate the achievement of liquidity

Muḍārabah Interbank Investment

- Islamic banks with excess reserve can invest that amount in the money market
- Banks with surplus will be the Rabb al-māl and the central bank will be the entrepreneur
- The profit sharing ratio between the Rabb al-māl and the entrepreneur must be pre-determined
- Money from the Sharī'ah point of view is not traded for money with an increase or on deferred payment

Short Term Ījārah Sukuk

- Is a short term Sukuk, whereby usufruct of the asset is transferred to another person in exchange for a rent claimed from him

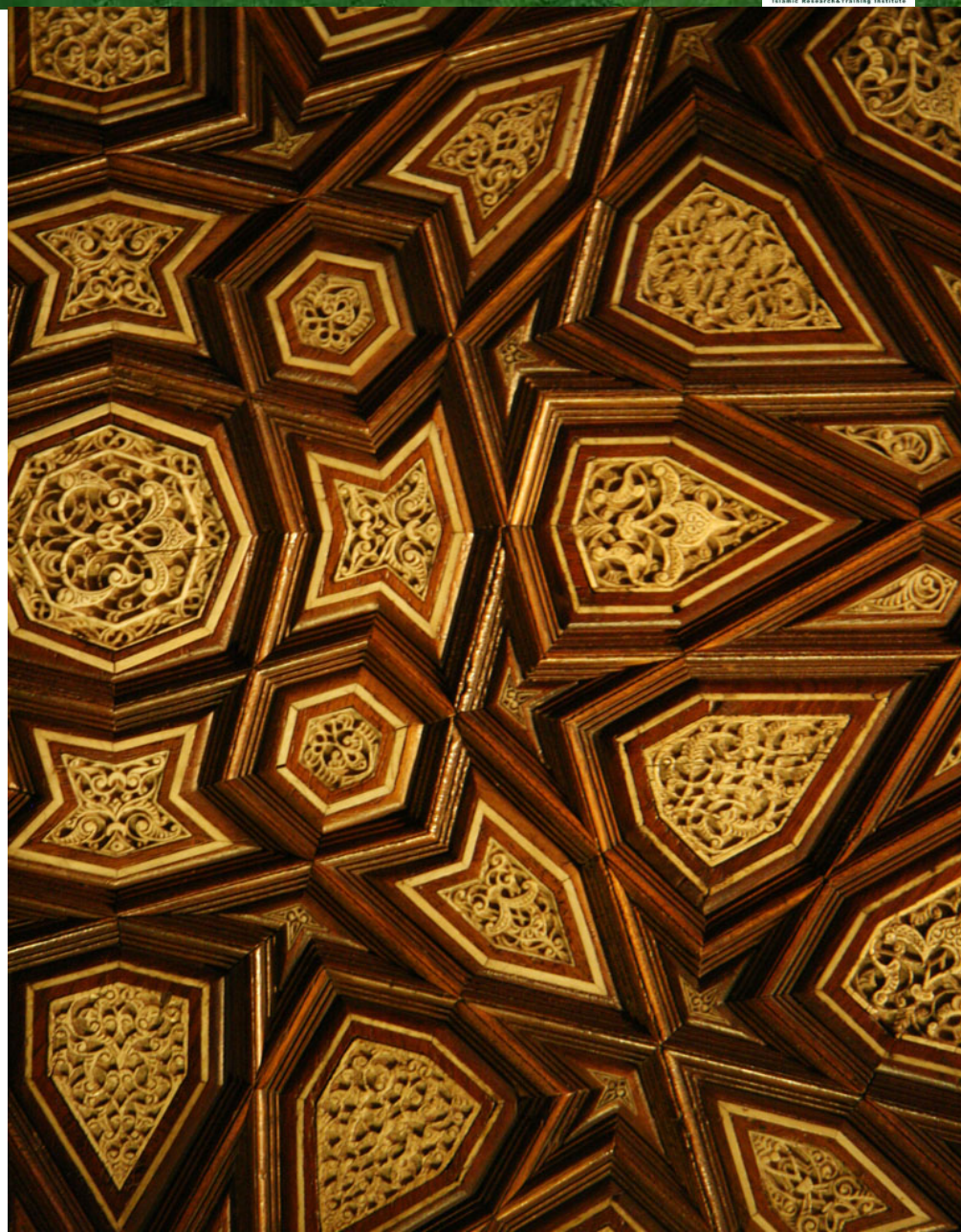
Mushārakah Certificates

- Represents the ownership of the holder in a proportion of the assets of the project
- It could be sold in the market only if it represents non-liquid assets
- If the certificate only represents a proportion of liquid assets of the project, it could not be sold in the market

Salam Sukuk

- Bank pays in advance for buying specified assets, which the seller will supply on a pre-agreed date
- The financier receives a discount for advance payment (calculated with reference to a benchmark, such as LIBOR, plus a margin)
- Certificates are issued by a Special Purpose Vehicle that entitle the holders to an ownership interest and a right to a return in proportion to their investment in the underlying bai salam

Takāful and Retākaful



What is Takāful?

The word Takāful is derived from the Arabic verb "Kafālah", meaning to aid or help out, which essentially suggests the importance of having shared responsibilities, solidarity and cooperation. It was practiced among Muslims of Makkah and Medina, who established the foundation of mutual insurance.

Takāful is a Sharī'ah-compliant alternative to an insurance scheme. It provides a protection plan based on Sharī'ah principles. The underlying features of Takāful primarily lie on solidarity and mutual protection with the main objective to uphold the principle of mutual assistance and shared responsibilities to take precautions against risks and misfortunes for all individuals constituting the group.

Economic need of Takāful

As a contributive mechanism, Takāful helps the economy to cultivate growth and prosperity

Takāful has been designed to help and stabilize the financial situation of individuals, families and organizations. Takāful operators meet the financing needs of large projects, thereby helping national economies by enlarging the set of feasible investment projects and encouraging economic efficiency.

Takāful helps the economies of Islamic countries to foster a more efficient allocation of capital and resources through promoting trade, commerce and entrepreneurial activities. A growing Takāful and Retakāful market is an instrument for economic growth of Islamic countries. In fact, the development of Takāful as an alternative to conventional insurance will contribute to economic prosperity of Islamic countries.

Basic Principles of Takāful

Risk Sharing

Risk is shared among the members of the Takāful fund. If an event occurs that causes harm or damage to one member, all members bear the effect of that incident and contribute to overcoming it. Takāful members cooperate based on equality, solidarity, social responsibility, and honesty.

Joint Obligation

Each member in the fund is responsible for lessening the hardships of the other members. The member of a Takāful fund shares the risks of all other members.

Every member's risks become the mutual responsibility of all other members.

Mutual Protection

Each member participates in protecting all the other members against loss or damage.

Takāful brings equity to all the parties involved in the operation. With this principle risks are divided among the fellow members of the society and Takāful brings a peace of mind to all the participants and improves their quality of life.

Participants' Unity

Participants have a unanimous and common interest while depositing their payments to a Takāful fund. They desire to protect themselves from harm originating from loss or damages.

What are the early forms of Takāful?

DIYĀH

The indemnity paid as "blood-money" to the next-of-kin or the injured party of a murdered victim.

KAFĀLAH

A surety ship whereby a third party guarantees the performance of another party involved in a contract. It was used to assist victims of hazards on trade routes.

MUWĀLAT

Aqd Muwalat is a contract to bring an end to mutual enmity or revenge.

DĀMAN

Daman Khatar Altariq is a guarantee against travel hazards. It is a mutual assistance in which losses suffered by traders during journeys due to hazards were indemnified from jointly pooled funds.

HILF

A pact for mutual assistance among people.

JUHALĀ

The commodity or the price is unknown, whereas in case of Gharar the contract and the obligations of the parties are certain to take place but one of the elements of the contract is not defined.

Solidarity, Brotherhood, Mutual Financial Aid, Assistance

In all these agreements, Arab tribes and traders covered the losses and liabilities of individuals in the form of solidarity and brotherhood, and provided mutual financial aid and assistance in case of need.

What are the basic Takāful models?

All Takāful models must be administrated by an operator with the best interests of the contributors.

- This profit sharing model gives the right to the contracting parties to share profit, while liability for losses is borne by the participants.

MUḌĀRABAH

- This agency model gives an advantage to the fund operators to get a fee in case of operational losses, which are borne by the participants.

WAKĀLAH

- Other business models such as **Waqf Model**, **Tābarru' Model** and **Hybrid Models** are also adopted by Takāful operators to a lesser extent.

OTHERS

The Muḍārabah (profit sharing) model

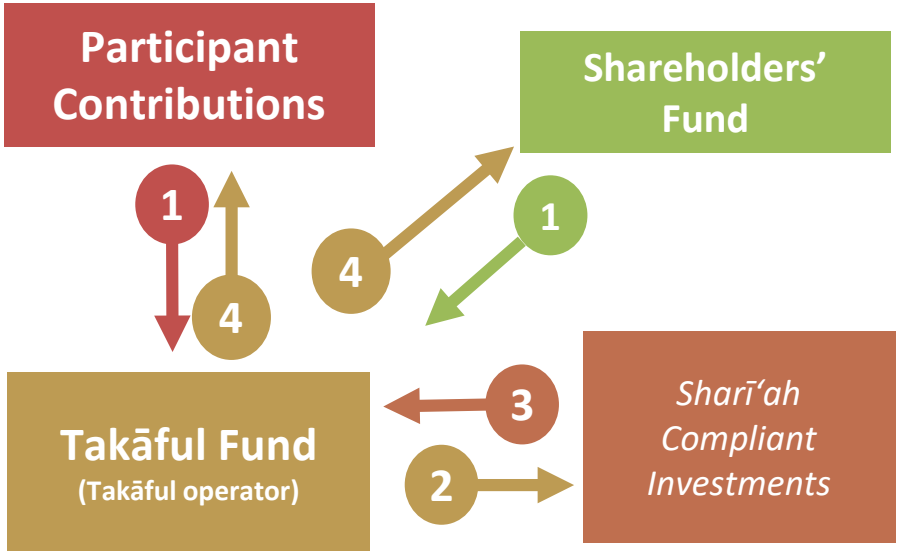
Under the Muḍārabah contract, the Takāful operator acts as a Muḍārib (entrepreneur) and the participants as Rabb al-māl (capital providers).

1. Takāful fund collects payments under the name of Takāful installments or Takāful contributions from the participants as well as capital providers.

2. Takāful operator invests the collected funds in Sharī'ah-compliant investments.

3. Takāful operator reclaims profits from the Investments or writes off the losses.

4. Takāful operator distributes and shares surpluses/dividends or reflects the losses to the fund participants and shareholders.

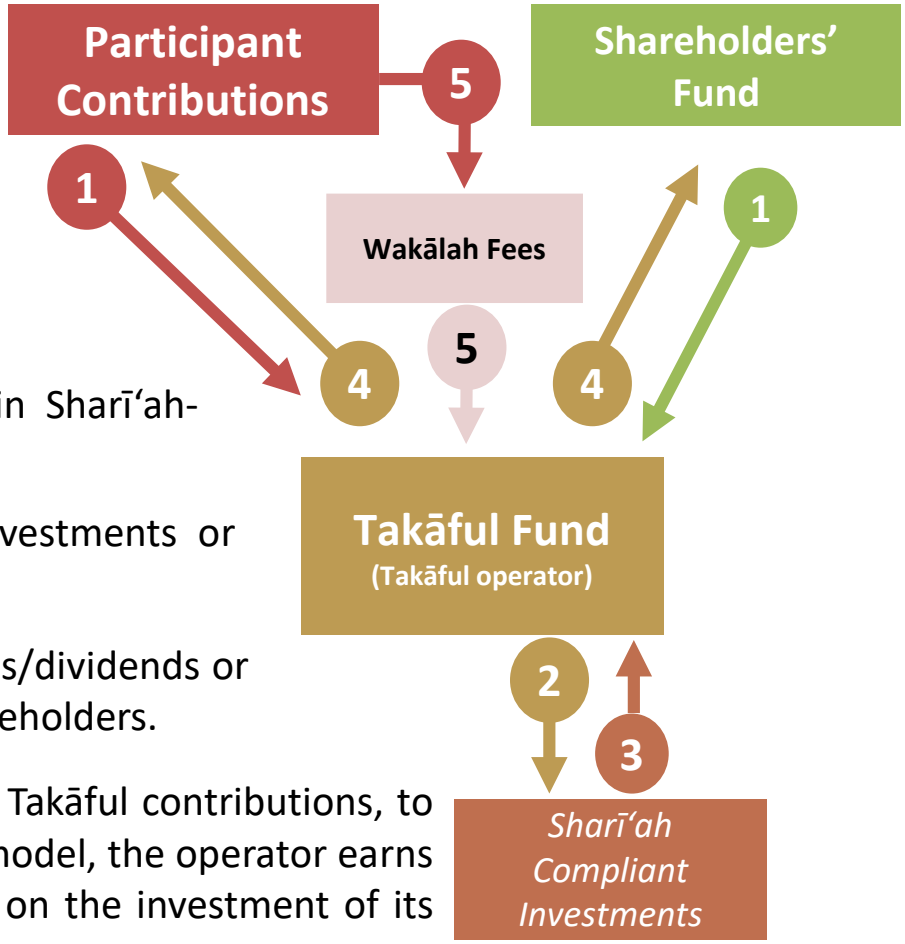


Profit sharing calculation between contracting parties may be in different ratios such as 50:50, 60:40, 70:30, 80:20 etc.

The Wakālah (agency) model

The Wakālah concept can be defined as an agent-principal relationship, whereby the Takāful operator acts as an agent in the best interests of the participants and earns a fee for his services.

1. An agency agreement has been signed between Takāful operator and shareholders as well as participants. Then, operator collects payments under the name of Takāful installments or Takāful contributions from the participants as well as capital providers.



2. Takāful operator invests the collected funds in Sharī'ah-compliant investments.

3. Takāful operator reclaims profits from the investments or writes off the losses.

4. Takāful operator distributes and shares surpluses/dividends or reflects the losses to the fund participants and shareholders.

5. A pre-agreed fee is being cut from participants' Takāful contributions, to be given to Takāful operator. Hence, through this model, the operator earns its income from the agency fee as well as returns on the investment of its shareholders' fund.

What are the main lines of Takāful products?

Family Takāful

It is based on the principle of self-help between a group of individuals and their families relating to protecting widows, orphans and other dependents of the indemnified against an unexpected hardship such as mishap or permanent disability.

Family Takāful
Investment Linked Takāful
Child Education Takāful
Medical & Health Takāful

General Takāful

It includes for instance possessions, properties or vehicles against fire and stealing. This area of Takāful operates similar to a multiparty assurance whereby all contributors jointly fund their shares of premiums into a pool to insure participants suffering injury or damage.

Personal Accident Takāful
Home Takāful
Motor Takāful

Takāful Companies	Insurance Companies
Works on mutual cooperation and benefit	Profitable dynamics have the priority
Interest (Ribā), gambling (Maysir), and uncertainty (Gharar) are not allowed	There is no additional condition on interest, gambling and uncertainty in the contracts
Accept contributions as a donation	Collect premium as a payment
Under the regulation and supervision of governing rules as well as Sharī'ah Laws	Under the regulation and supervision of governing rules
Shareholders and participants have the excess amount and the profit	Shareholders have the excess amount and the profit
Provides protection against loss from fund operations	Provides protection against all types of losses

What is Retakāful?

An Islamic alternative of the reinsurance industry. In a traditional insurance system, an insurance company minimizes its risk of paying large claims by insuring a portion of its risk with another insurance company. The third party is called a reinsurer, and it relieves the insurance company in situations which involves fires, riots, natural disasters and other major events that significantly affect many policyholders at once.

Retakāful can be defined as the Islamic form of reinsurance. Hence, Retakāful is a practice of company to company insurance whereby a Takāful operator transfers part of its risk to a different Takāful operator to mitigate some of the loss. A pre-arranged premium is paid from the Takāful fund to the Retakāful company to get full security for possible risk.

How Retakāful works?

Retakāful operates the same way that Takāful does. The only difference is that in a Retakāful contract, participants (policyholders) are various Takāful companies, and the fund operator is the Retakāful company whereas participants (policyholders) of regular Takāful products are individuals, businesses, and other commercial organizations.

Why is Retakāful important?

Systemic risk management: Takāful operators need to be attentive on the systemic risks, to which many of their participants may be exposed at the same time. To manage this, Takāful companies may be supported by Retakāful institutions so as to spread the risks even wider.

Capacity constraints of Takāful operator: Takāful operators, at times, are requested to undertake Takāful on projects which are huge and beyond the capacity of a single operator. Retakāful helps them diversify and pass some of this risk to a bigger player.

Protection of the Takāful fund against massive claims: Takāful operators diversify the overheads of paying out on outsized risks by Retakāful.

Even out claims: Takāful fund operators want a balanced set of underwriting results each year, without significant variations in their financial results. Since Retakāful protects them against bulky losses, this retains a cap on the claims that the Takāful operator has to pay out.

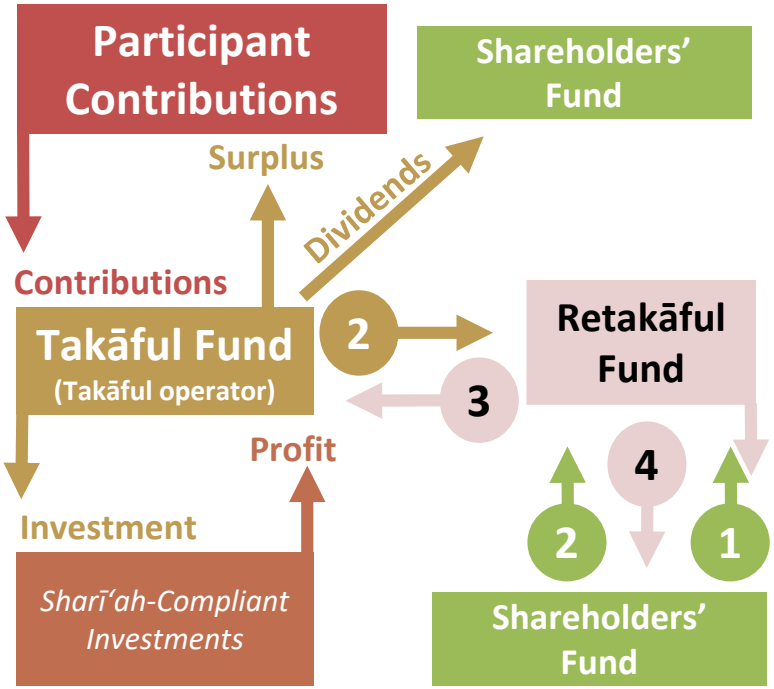
Retakāful Model

As a main principle of Takāful, mutual protection has come into place for Retakāful as well. In this new concept Takāful pool has been extended to the Retakāful pool. A corporate body will be the new operator for the Retakāful fund and acts as a manager of the Retakāful pool.

1. An agency agreement has been signed between Retakāful operator and shareholders.

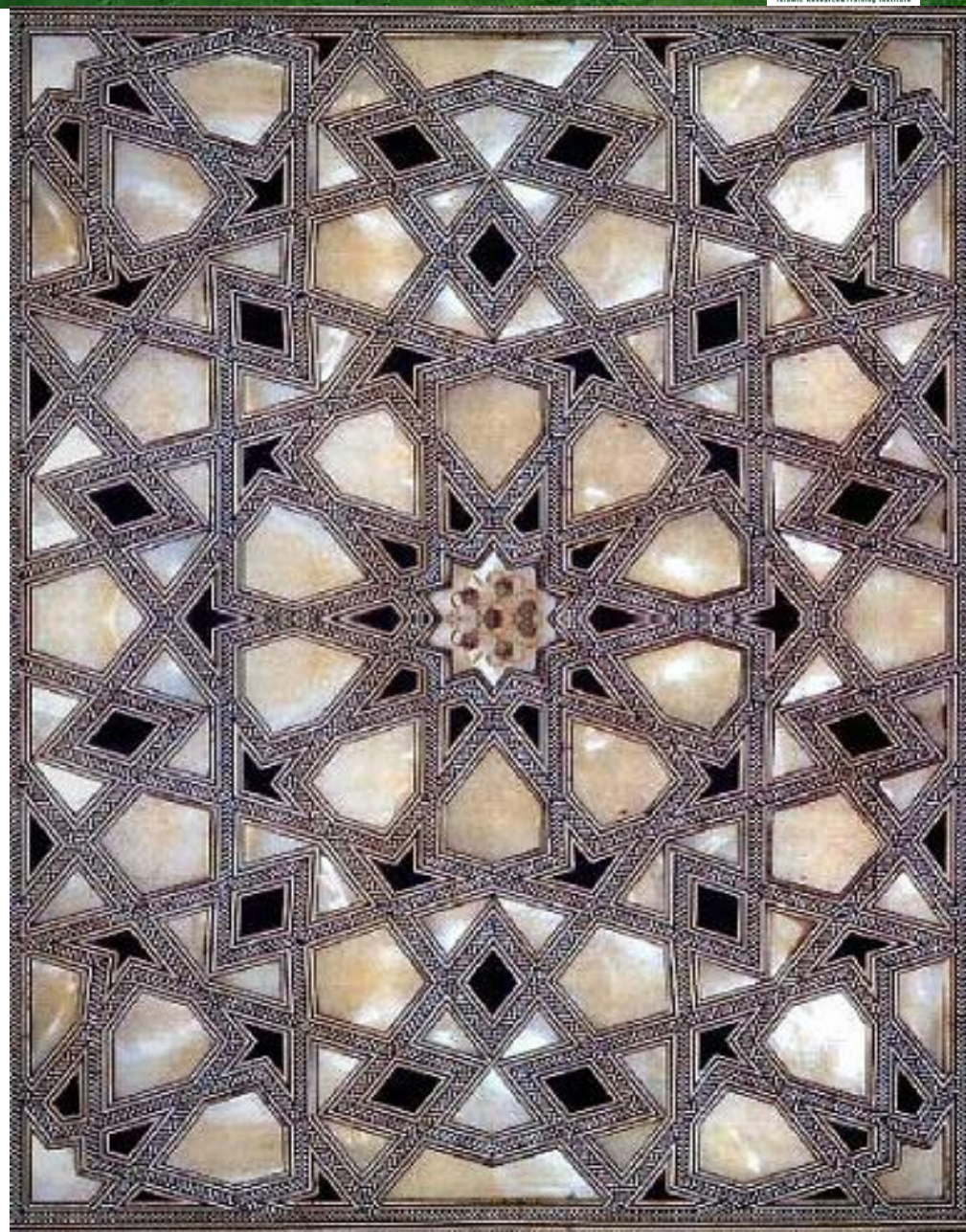
2. Shareholders' fund has been established as a capital of the fund. Then, Takāful operator deposits the payments under the name of Retakāful installments to the Retakāful fund.

3. Retakāful operator distributes the surpluses to the Takāful fund. The Retakāful fund operator has no right to ask for all of the contributions from the collected funds of Takāful to its own pool.



4. Retakāful operator distributes the dividends to the shareholders.

Islamic Social Finance



What is Islamic Social Finance?

- Islamic Social Finance (ISF) broadly comprises the traditional Islamic institutions based on *philanthropy* and *mutual cooperation* as well as the more contemporary institutions of *not-for-profit* Islamic microfinance.

- Islamic Social Finance covers aspects of Islamic Finance beyond the mainstream banking and finance sector.

- The main focus of Islamic Social Finance is on the alleviation of hardship, poverty and human suffering through mobilization and channelization of financial and material resources to the destitute and needy.

Why is Islamic Social Finance important?

- Islamic Social Finance is deeply rooted in the fundamentals of the Islamic faith and is an integral part of the Islamic social fabric that enjoins compassion, brotherhood and duty to other human beings and society.

- Looking after the basic needs of the poor is a collective obligation (Fardh al-Kifāyah) of an Islamic society.

Basic Needs

Collective Obligation

- Thus zakāh, one of the five pillars of Islam, is a financial obligation on the wealthy to share part of their wealth with the poor and needy segments of society.

- Similarly, philanthropy and other ways of mutual assistance are strongly encouraged in Islam to ensure circulation and redistribution of wealth such that the overall welfare of the society is maximized.

What are the main models and instruments of Islamic Social Finance?

The main models and instruments of Islamic Social Finance can be classified into three broad categories.

Irrespective of the category and instrument, the common objective of Islamic Social Finance is to enhance the welfare and well being of human beings through ensuring fulfilment of basic needs and financial inclusion.

Philanthropy

- Zakāh
- Sadaqah
- Waqf

Mutual Cooperation

- Qard al-ḥasan
- Kafālah

Not-for-Profit

- Islamic Microfinance

What is zakāh?

Zakāh is a compulsory annual levy on Muslims. It is one of the five pillars of Islam and its importance is such that it has been mentioned 30 times in the Holy Qur'an.

And establish prayer and give zakah and bow with those who bow [in worship and obedience].

Holy Qur'an, (3:92)

Zakāh is collected:

- On wealth owned for one Hijrī calendar year (Ḥawl)
- Must be equal to a minimum threshold (Niṣāb) or more
- Not on income used for consumption
- On savings added to wealth of an individual during the year, and on agricultural output

How is zakāh calculated?

Zakāh is levied on both assets (stock concept) and outputs (flow concept).

On assets, zakāh is generally 2.5% of the asset value e.g. gold, silver and currency.

On outputs e.g. agricultural produce, zakāh is levied at 5% of gross or 10% of net output.

In all cases, assets or outputs have to be above a minimum threshold called (Niṣāb).

For assets, e.g. money or cattle, the passage of one calendar year (Hāwl) is also a condition.

For outputs, e.g. agriculture produce, Hāwl is not necessary and payment becomes due at the time of harvest .

Zakātable Items

What is the Niṣāb (minimum threshold) of zakāh?

- The Niṣāb for gold, silver and money is 85 grams of gold or 595 grams of silver or cash equivalent.

85 grams

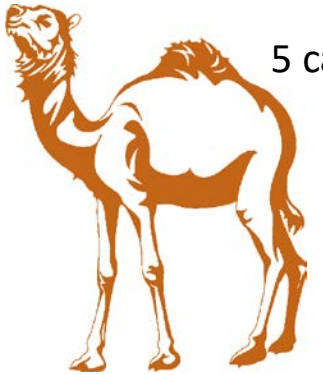
595 grams

- The Niṣāb for agricultural produce is five *wasq* (652.8 kg) of wheat or equivalent.

652.8 kg

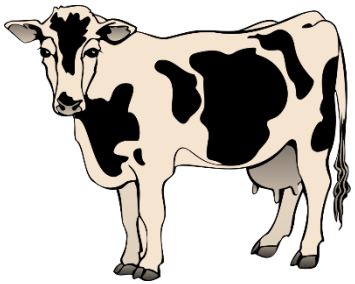
- For agricultural produce, zakāh is payable at each harvest.

- The Niṣāb for cattle is as follows:



5 camels

30 cows



40 sheep

Who are entitled to receive zakāh?

The recipients of zakāh are clearly specified in the Holy Qur'an. The proceeds of zakāh can only be distributed among the following 8 categories:

1. Poor
2. Needy
3. Administrators and collectors of zakāh
4. Whose hearts are to be won over
5. Freeing human beings from bondage
6. Those overburdened with debts
7. Struggle in God's cause
8. The wayfarers

While interpretation of the categories allows for a wide range of causes that can be supported through zakāh, the primary objective remains poverty alleviation and provision of basic human needs.

Zakah expenditures are only for the poor and for the needy and for those employed to collect and for bringing hearts together and for freeing captives and for those in debt and for the cause of Allah and for the traveler - an obligation by Allah. And Allah is Knowing and Wise. Holy Qur'an, (9:60)

What is sadaqah?

- Unlike zakāh, which is a compulsory annual levy, sadaqah is voluntary and not bound by any conditions of time, Niṣāb or amount/rate.
- The essence of sadaqah is to share one's wealth and good fortune out of kindness, compassion, brotherhood and generosity.
- Sadaqah also has a wider meaning in Islam.

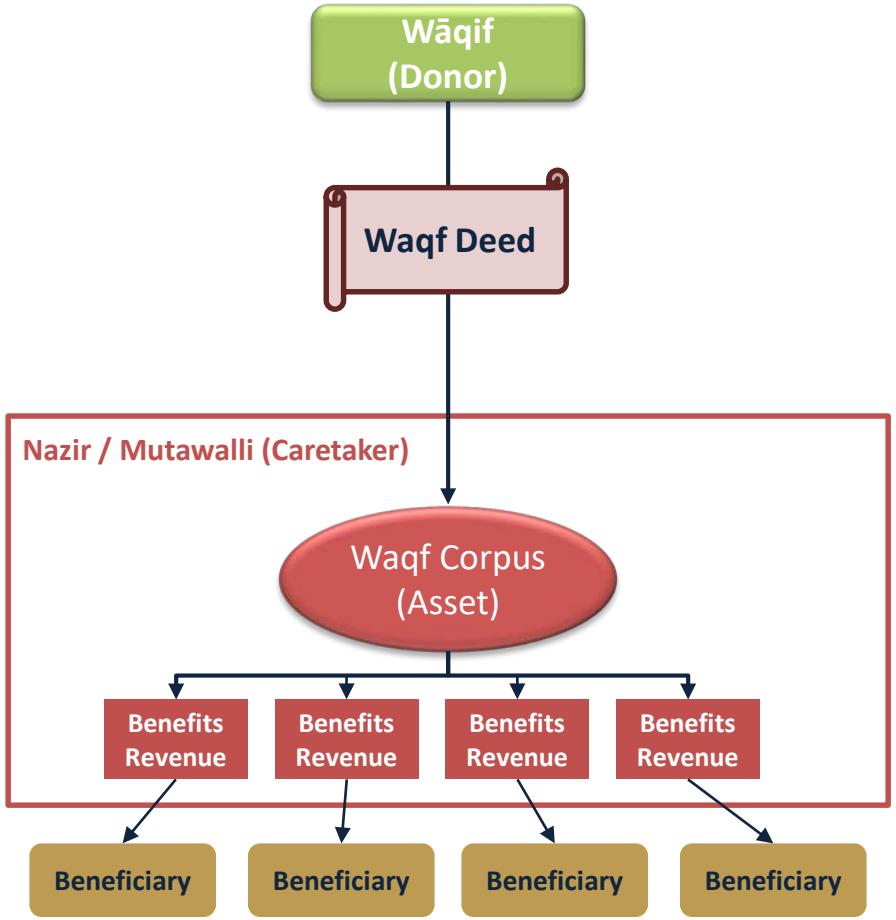
Abu Hurairah (RA) reports, the Prophet (PBUH) said:

"Sadaqah is due on every joint of a person, every day the sun rises. Administering of justice between two men is also a sadaqah. And assisting a man to ride upon his beast, or helping him load his luggage upon it, is a sadaqah; and a good word is a sadaqah; and every step that you take towards prayer is a sadaqah, and removing of harmful things from the pathway is a sadaqah." ***(Sahih Muslim)***

What is waqf?

- Waqf (plural: awqāf) is defined as a *perpetual endowment.* It is also known as *Habs.*
- Creating a waqf involves setting aside certain assets by the donor (wāqif) and preserving them so that benefits continuously flow to a specified group of beneficiaries or community.
- The corpus (endowed asset) of a waqf can be real estate or cash.
- A waqf is created by the wāqif through a waqf deed specifying the purpose of the waqf, its beneficiaries, its caretaker (Nazir/Mutawalli) and the mechanism of caretaker's compensation.

Waqf Mechanism



What are the main features of waqf?

The following are the main features of a waqf:

- Irrevocability – Waqf made cannot be taken back
- Perpetuity – Waqf corpus to remain intact
- Purpose* – Objectives of waqf to be clearly defined
- Permanence** – Benefits to continue indefinitely
- Honesty and Integrity*** – In management of waqf

* While the purpose of a religious waqf e.g. mosque, is always perpetual, the purpose of a philanthropic waqf may become obsolete. In this case, the benefits may be transferred to a similar cause or for the betterment of the poor and needy

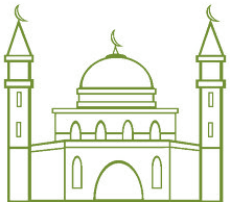
** A waqf may also be created for a defined period e.g. the use of a building for a period of 10 years as a school or hospital after which it reverts to the owner

*** The Mutawalli/Nazir is accountable to Allah in terms of performing his duty to manage the waqf in line with the best interest and instructions of the wāqif

Waqf King Abdul Aziz for the Two Holy Mosques

What are the different types of waqf?

Waqf can be categorized as follows:



- Direct Waqf: Asset to be used itself by community
- Religious Waqf: e.g. Mosque, Islamic School

- Cash or Stocks Waqf:

Like investment waqf, only that asset is cash to be invested or stocks and securities. Revenues are used for waqf benefit

- Investment Waqf: Asset generates revenue which is used for benefit
- Philanthropic Waqf: Revenue from asset goes to fund education for needy children

The Dome of the Rock & Al Aqsa Mosque are both managed through awqāf

Why is zakāh, sadaqah and waqf important?

- Ultimately, philanthropy in Islam is an expression of piety and righteousness.
- It also reinforces Islam's emphasis on social responsibility, human welfare and the well being of others.
- Zakāh has been made compulsory and is the *right* of those who are less fortunate.
- Sadaqah is voluntary but strongly enjoined to enhance mutual support and strengthen the social bond of society.
- Waqf is a perpetual gift that generates perpetual rewards for the wāqif and was the cornerstone of the welfare state of Islam.

You shall never attain piety until you give from what you love.

Holy Qur'an (3:92)

WAQF

75% All arable land in the Ottoman Empire

50% Algerian lands under French occupation in 19th century

33% Tunisian lands in 19th century

What is Qard al-ḥasan?

- Qard or Qard al-ḥasan in Islam is a benevolent loan in that it does not accrue any interest or profit. However, the borrower has to pay back the borrowed amount.

- While Islam strongly discourages borrowing money unless absolutely necessary, it enjoins lending money to those in need to meet their basic needs.

Who is it that would loan Allah a goodly loan so He may multiply it for him many times over? And it is Allah who withholds and grants abundance, and to Him you will be returned.

Holy Qur'an (2:245)

- In modern Islamic banking, the current account deposit may be based on the Qard al-ḥasan concept whereby the depositor lends money to the bank and reserves the right to demand it at any time.

- Because the borrower has the right to use the money as he pleases, the Islamic bank can invest that money. However, no interest or profit is payable to the depositor.

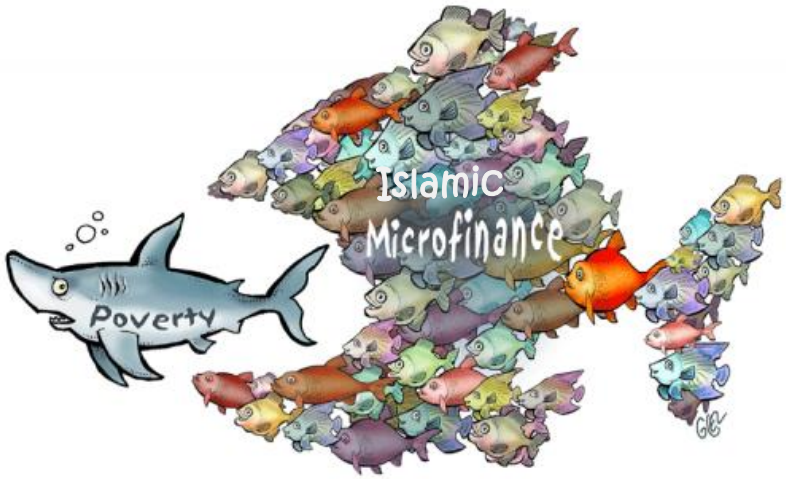
Why is Qard al-ḥasan important?

- Within the context of Islamic Social Finance, Qard al-ḥasan is important as it:
  - helps fellow human beings in need by providing their immediate needs;
  - improves relationship and bridges the gap between the poor and the rich;
  - mobilizes wealth among people in society;
  - helps the poor in using their skills and expertise;
  - promotes a caring society; and
  - reduces social and economic discrimination in the society.
- The advantage of Qard al-ḥasan over sadaqah is that it is more sustainable as the money can be given again as a Qard al-ḥasan.
- The loss due to opportunity cost, inflation and other factors is what makes Qard al-ḥasan an act of philanthropy in Islam.

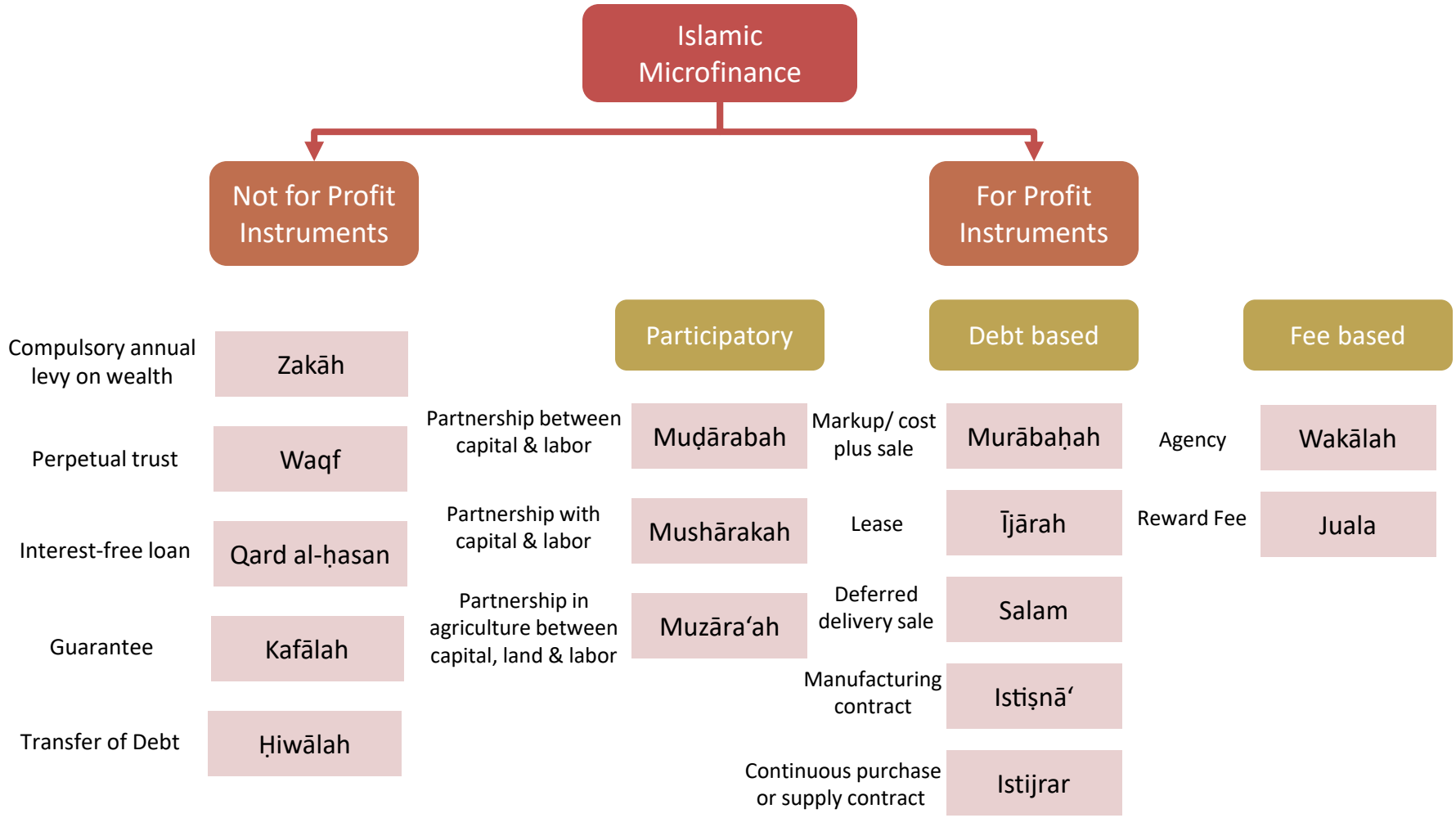
The rich poor divide – San Paulo, Brazil

What is Islamic Microfinance (IsMF)?

- IsMF is microfinance using Sharī‘ah-compliant instruments and structures.
- IsMF is still at a very early stage and represents less than 1% of global microfinance programs.
- IsMF can be used for prevalent microfinance models such as:
  - Joint Liability Groups e.g. Grameen.
  - Self Help Groups e.g. in India.
  - Community/Village Banks e.g. Bank Perkreditan Rakyat (BPR) in Indonesia, Jabal Hoss in Syria.
  - Credit Unions/Cooperatives e.g. Baitul Maal Wa Tamwil (BMT) in Indonesia.



What are the main instruments of Islamic Microfinance (IsMF)?



Why is Islamic Microfinance important?

- Islamic microfinance is an important means of ensuring financial inclusion for the poorest of the poor, who are unable to avail or qualify for mainstream financial products due to lack of collateral, credit history and reputation.

- Islamic microfinance combines elements of mainstream microfinance such as collectivism, cooperatives, self help etc. with Sharī'ah-compliant instruments to deliver financial products designed to meet the requirements of the target market.

- Islamic microfinance may be combined with other philanthropic instruments such as Qard al-ḥasan, zakāh, sadaqah and waqf to reduce the cost of finance to the recipients.

Sharī‘ah Governance

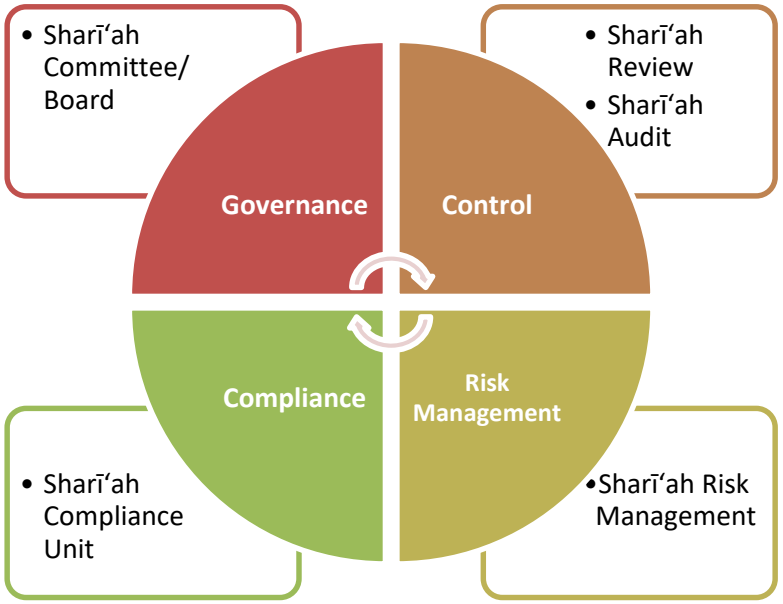
What is Sharī‘ah governance?

- Sharī‘ah governance is defined* as *"a set of institutional and organizational arrangements to oversee Sharī‘ah compliance aspects in Islamic Financial Institutions (IFIs)"*.

- In addition to corporate governance, which is critical to the management and control of any financial institution, IFIs also need to ensure that all their products, instruments, operations and practices are in line with Sharī‘ah.

- IFSB, AAOIFI and other international Islamic infrastructure setting institutions have developed guidelines and best practices for IFIs to follow to ensure that they put in place appropriate structures and mechanisms for Sharī‘ah compliance.

Sharī‘ah Governance Framework



*IFSB-10

Why is Sharī‘ah governance important?

Sharī‘ah governance is extremely critical for any IFI because:

- Key differentiator between an Islamic and conventional financial institution.
- Legitimizes a financial institution as “Islamic” and creates credibility.
- Provides confidence to shareholders, regulators, customers and the public that the operations of an institution are compliant with Sharī‘ah.
- Protects the IFI from reputational and fiduciary risks.
- Ensures Sharī‘ah compliance both in actuality and perception.

What are some of the main models of Sharī‘ah governance?

There is no single model for Sharī‘ah governance and different jurisdictions follow different practices. These include:

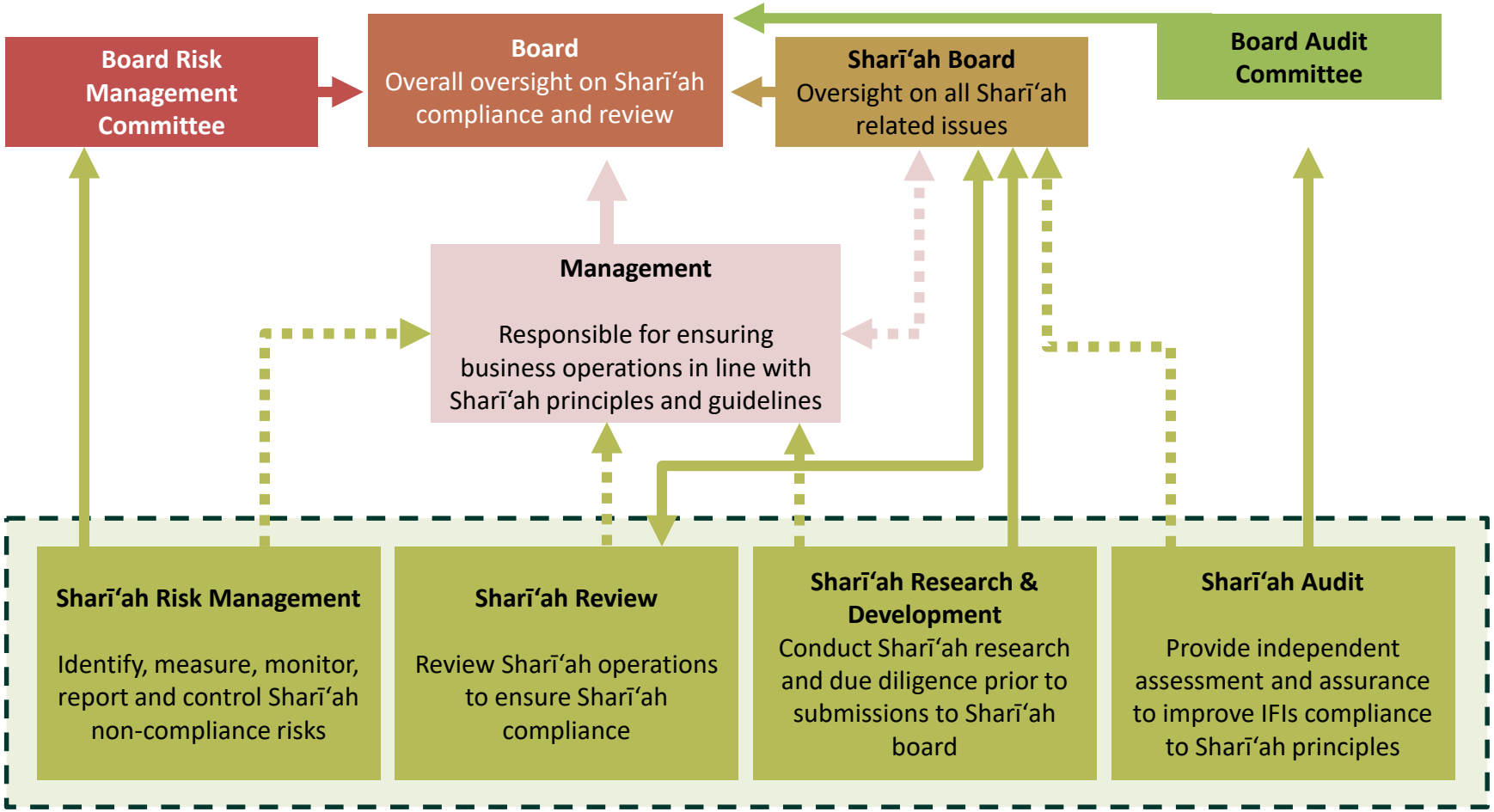
One tier model:
- Sharī‘ah supervisory body required at the individual IFI level only.
- No higher authority to oversee the rulings of individual IFIs Sharī‘ah supervisory board and no such requirement being provided in the central bank regulation.
- Examples are Saudi Arabia and Qatar.

Two tier model:
- A central apex Sharī‘ah body at the country level with respective Sharī‘ah supervisory boards at IFIs level.
- Roles and responsibilities of each body clearly defined in central bank regulations.
- Apex Sharī‘ah body is the supreme authority on matters relating to business operations or transactions.
- Individual IFI Sharī‘ah supervisory boards have to abide by the rulings of the apex body.
- Examples are Bahrain, UAE, Indonesia, Malaysia, Pakistan and Sudan.

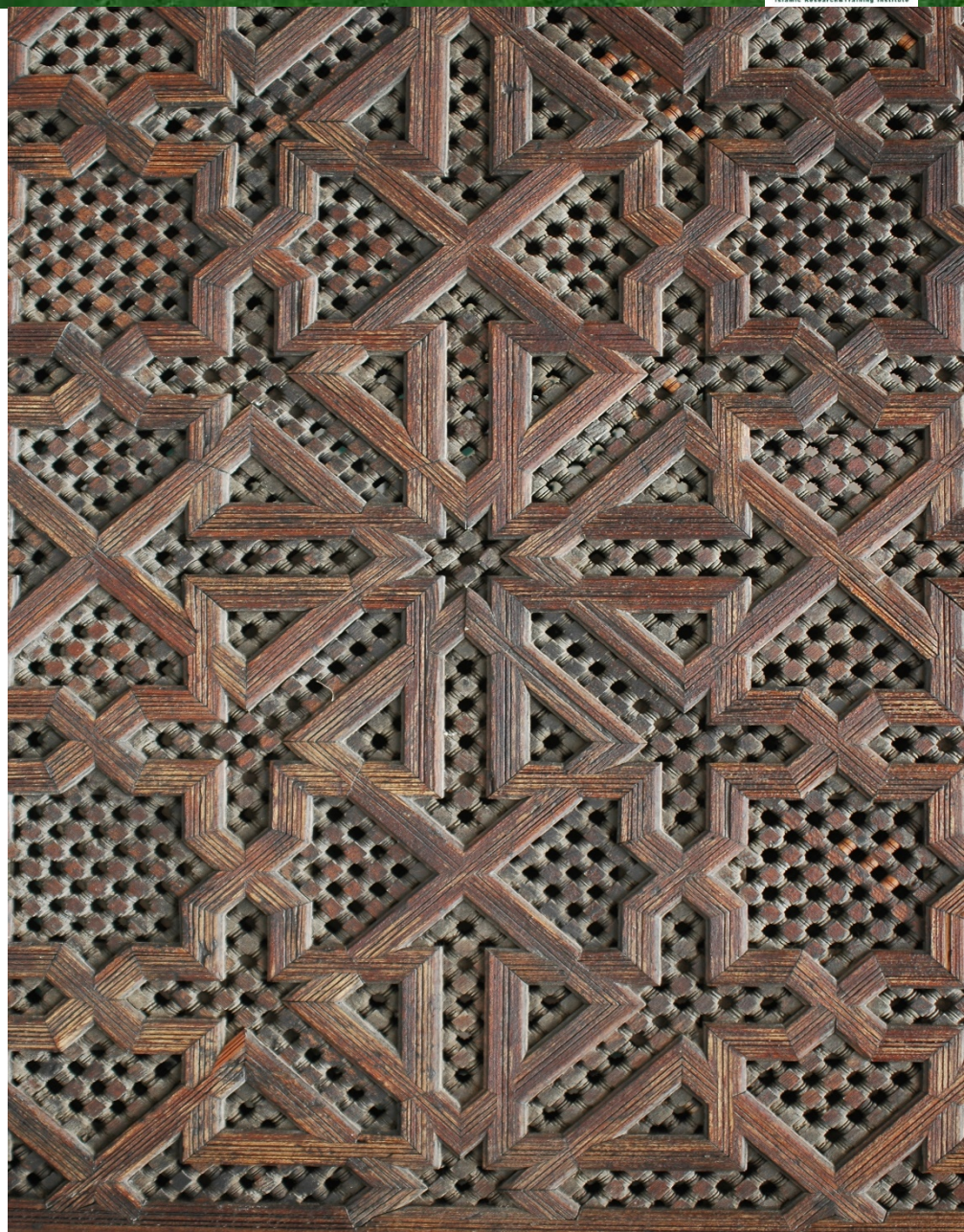
Hybrid model:
- Sharī‘ah supervisory body exists at the IFIs level but a national Sharī‘ah board may be referred to in case of conflict among the members of the Sharī‘ah supervisory board.
- In such event, the BoD of the IFI *may* transfer the matter to the national Sharī‘ah board for final ruling.
- Example is Kuwait.

How does a typical Sharī‘ah governance structure look like?

ILLUSTRATIVE



Glossary



Al- Qur'an (القرآن)	The Holy Book of Muslims, comprising the revelations made by Allah to Prophet Muhammad, peace be upon him. The Qur'ān (القرآن)lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.
Awqāf (أوقاف)	Plural of waqf (وقف). For meaning, see below.
Bay' (بيع)	Sale. It is often used as a prefix in referring to different sales-based modes of Islamic finance, like murābaḥah (مُرابحة), ījārah (إيجارة) , Istiṣnā' (استصناع), and salam (سَلَم).
Bay' al-dayn (بيع الدين)	Sale of debt. According to a large majority of fuqahā' (فُقهاء), debt cannot be sold except at its face value.
Bay' al-salaf (بيع السلف)	An alternative term for bay' al-salam (بيع السَلَم).
Bay' al-salam (بيع السَلَم)	Sale in which payment is made in advance by the buyer and the delivery of goods is deferred by the seller.
Falāḥ (فَلاح)	Literally it means to become happy, to have success. Technically, it means achieving success in the life Here and Hereafter.
Fardh al-Kifāyah (الفرض الكفاية)	Sufficiency duty or Fardh al-Kifāya (الفرض الكفاية) is a duty which is imposed on the whole community of believers (ummah). The classic example for it is janaza: the individual is not required to perform it as long as a sufficient number of community members fulfill it.
Fatāwa (فتاوى)	Plural of fatwah (فَتوة), meaning religious verdict by a faqīh (فقيه).
Fiqh (فقه)	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, fiqh (فقه) covers all aspects of life, religious, political, social, commercial or economic. The whole corpus of fiqh (فقه)is based primarily on interpretations of the Qur'ān (قرآن) and the Sunnah (سُنة) and secondarily on ijmā' (إجماع) (consensus) and ijtihād (اجتهاد) (individual judgment). While the Qur'ān (قرآن) and the Sunnah (سُنة) are immutable, fiqhī (فقهي) verdicts may change due to changing circumstances.
Fuqahā' (فُقهاء)	Plural of faqīh (فقيه) meaning jurist who gives opinion on various juristic issues in the light of the Qur'ān (قرآن) and the Sunnah (سُنة).

Gharar (غرر)	Literally means deception, danger, risk and uncertainty. Technically it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfill his commitment, or ambiguity in the terms of the deal, thereby exposing either of the two parties to unnecessary risks.
Ḥādīth (حديث)	Sayings, deeds and reactions of Prophet Muhammad, peace be upon him, narrated by his companions.
Ḥalāl (حلال)	Things or activities permitted by the *Sharī'ah* (شريعة).
Ḥarām (حرام)	Things or activities prohibited by the *Sharī'ah* (شريعة).
Ḥiwālah (حوالة)	Literally means bill of exchange, cheque, draft. Technically, it refers to an arrangement whereby a debtor passes on the responsibility of payment of the debt to a third party who owes former a debt.
Ījārah (إيجارة)	Leasing. The subject matter in the leasing contract is an asset, such as machinery, airplanes, cars, or ships, which generates usufruct over time. This usufruct is sold to the lessee at a predetermined price. The lessor retains the ownership of the asset with all the rights as well as the responsibilities that go with ownership.
Ijtihād (اجتهاد)	In technical terms it refers to the endeavor of a jurist to derive a rule or reach a judgment on the basis of evidence found in the Islamic sources of law, predominantly the *Qur'ān* (قرآن) and the *Sunnah (سُنة)*.
Istiṣnā' (استصناع)	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. As against *salam* (سَلَم), the price here need not be paid in advance. It may be paid in installments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.

Kafālah (الكفالة)	A contract whereby a person accepts to guarantee or take responsibility for a liability or duty of another person.
Muḍārabah (مضاربة)	A contract between two parties: capital owner(s) or financiers (called *rabb al-māl* رب المال) and an investment manager (called *muḍārib* مُضارب). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.
Muḍārib (مضارب)	Investment manager in a *Muḍārabah* (مضاربة)contract.
Murābaḥah, (بيع المُرابحة)	Sale at a specified profit margin. The term is, however, now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in installments or lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. *Murābaḥah* (مرابحة)is also referred to as *bay' mu'ajjal* (بيع المؤجل).
Mushārakah (مُشاركة)	A *Mushārakah* (مُشاركة)contract is similar to *Muḍārabah* (مُضاربة), with the difference that in the former both partners participate in the management and the provision of capital, and share in profit and loss. Profits are distributed between partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in capital.
Muzāra'ah (مُزارعة)	A contract whereby one party agrees to till the land owned by the other party in consideration for an agreed share in the produce of the land.
Qard al-ḥasan (قرض الحسن)	A loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God.

Qiyās (قياس)	Derivation and application of a rule/law on the analogy of another rule/law if the basis (*'illah* علة) of the two is the same. It is one of the secondary sources of Islamic law.
Rabb al-māl (رب المال)	Capital owner (financier) in a *Muḍārabah* (مضاربة) contract.
Ribā (ربا)	Literally means increase or addition, and refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. It is regarded by a predominant majority of Muslims to be equivalent to interest as commonly known today.
Sharī'ah (شريعة)	Refers to the corpus of Islamic law based on divine guidance as given by the Qur'ān (قرآن) and the *Sunnah* (سُنة) and embodies all aspects of the Islamic faith, including beliefs and practices.
Sunnah (سُنة)	The *Sunnah* (سُنة) is the most important source of the Islamic faith after the Qur'ān (قرآن) and refers to the Prophet's example as indicated by his practice of the faith. The only way to know the *Sunnah* (سُنة) is through the collection of *Aḥādīth* (أحاديث),which consist of reports about the sayings, deeds and reactions of the Prophet, peace be upon him.
Wadī'ah (وديعة)	A contract whereby a person leaves valuables with someone for safekeeping. The keeper can charge a fee, even though in Islamic culture it is encouraged to provide this service free or to recover only the costs of safekeeping without any profit.
Wakālah (وَكالة)	Contract of agency. In this contract, one person delegates someone else to perform a certain task on his behalf, usually against a fixed fee.
Waqf (وقف)	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives of the *waqf (وقف).*
Zakāh (زكاة)	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy.

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