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Islamic Finance is Gaining Momentum Around the World

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ABSTRACT

Most people still have little understanding and information about how Islamic banking system works. Misconceptions drive people to think that there is no real difference between Islamic banking and the traditional financial system. The root of the issue, in author's humble opinion, simply lies with the fact that people don't differentiate between such concepts as "riba" and "ribh" in terms of how they are formed. This article explains the essence and nature of the formation of these two concepts, while also presenting some insights that might serve as justifications for forbidding the practice of "riba" and gives a list of Shariah requirements for the most common Islamic finance product – Murabaha.

1. Introduction

Let's probably start with the fact that when people come to an Islamic bank and find out that the Islamic bank uses percentage rate when it calculates a markup on goods, they fall into a stupor. What happens in people's heads is something like the following: «How is this possible? Do Islamic banks use percentage rates too? Percentage rate is riba, haram». Thus, many, not seeing the difference, begin to say that a conventional bank and an Islamic bank are one and the same. Therefore, this gave impetus to the spread of the myth that Islamic banks use haram interest.

Many people misinterpret the use of percentage practices of Islamic banks by assuming that they are similar to traditional banks. It is important to understand the difference: Percentage in itself is not "haram" (forbidden). It is simply a mathematical symbol, a measurement tool, or a method of expressing meaning. For example, when a merchant sets the price of a product, he may use a percentage markup to determine the final price. Or an engineer when he calculates a project for any construction project.

The problem arises when percentage is applied to money when it is lent. In Islam, when percentage is applied to money it is called usury and is considered haram. Islamic banks use the Murabaha model, where the bank buys a product, adds a certain markup (percentage) on the product and then sells the product to the client. This is considered acceptable, since the bank sells goods and does not lend money at interest. The proof is an Ayat from the Quran: as stated in Surah al-Baqarah, Ayat 275: "Allah has permitted trade, but has forbidden usury." This confirms the practice of Islamic banks in using interest rate for goods rather than for loans. Islamic banks operate within the framework of Shariah law, sell goods at a premium, and do not provide loans at interest. Therefore, it is incorrect to compare them with traditional banks that provide money at interest.

2. Murabaha as a Method of Financing

According to the definition given by Mufti Taqi Usmani, Murabaha is an ordinary transaction for the sale of goods. In Islamic banks, Murabaha is considered a means of financing. The bank uses the Murabaha agreement to sell to the client a certain product in installments, previously purchased by the bank itself, at an inflated price. There, the price of the product is determined accurately, including the agreed margin. The financing scheme is as follows:

i. The client contacts the Islamic bank to purchase the necessary goods;
ii. The Islamic bank purchases goods from the supplier;
iii. The Islamic bank enters into a Murabaha agreement with the Client and transfers ownership of the goods to the Client;
iv. The client pays periodic payments (installments) until full fulfillment of obligations.

3. Markup in the Murabaha Agreement

The term “Murabaha” comes from the word “Ribh” (Arabic for “Markup”). In the context of Islamic banking, the Murabaha trade margin is the amount of money added by the Islamic bank to the cost of the goods. This is the way the Islamic bank generates its profit. The size of this markup in the Murabaha agreement can be specified either as a specific amount or as a percentage of the cost of the goods. One of the most important conditions of the Murabaha transaction is that upon signing the contract, the price of the product (cost + markup) is fixed and cannot be changed subsequently.

4. The Difference Between Loan Interest and Markup

Riba (loan interest) and Ribh (margin) are fundamentally different in how they are formed. In the case of Ribh, trade occurs in the real sector of the economy, that is there is a real product or material value.

The wisdom of Allah in prohibiting riba can be illustrated by the example of the Global Financial Crisis in 2008. Back then, many banks provided mortgages to people who, to put it bluntly, were not creditworthy. When deciding to issue a loan, banks did not pay due attention to such important factors as whether the borrower has a stable job or a profitable business, confirming their ability to make monthly payments on time.

What happened as a result of the thoughtless issuance of loans? The mechanism of financial collapse can be illustrated by the following situation. Let's say a bank issued a $1 billion mortgage with the expectation that it would be paid back in the form of $2 billion after ten years. However, the bank did not want to wait decades. Instead, it grouped all its mortgage contracts together to create an investment product known as a "derivative." This package of derivatives was sold for 1.5 billion to another bank, which was willing to wait 10 years to receive the expected profit. Thus, the first bank not only returned its investment, but also made a profit of 500 million. But the story didn't end well for the second bank. After purchasing the derivative, the bank discovered that many borrowers were unable to pay their debts. As a result, the second bank suffered losses and was forced to declare bankruptcy.

Another piece of wisdom is that when money is treated as a commodity and only one organization has a monopoly on issuing it, an interesting situation occurs. Imagine that I am the main shareholder of this monopoly structure, independent of the government. I am given the legal authority to issue currency. Having issued, for example, 1 billion and provided it to some state at interest, I expect a return of 1.5 billion. When the time comes for a return, this state will not be able to return the additional 500 million to me, for one simple reason that this money does not yet exist in nature, because... they were not issued by me, in other words, this money is not yet in circulation. What's next? I force the state to engage in additional borrowing or pledge its resources - land, minerals, and so on. This results in an increase in the money supply without a corresponding increase in the volume of goods and services, causing inflation.

The following historical situation that happened with Kazakhstan serves as an illustrative example and validates the abovesaid words: "Until the first half of 1992, Kazakhstan received money from the Central Bank of Russia for free, and then, after the division of budgets, the ruble had to be purchased, and then the country immediately felt a cash shortage. Kazakhstan had to take rubles "on credit"; Russia later issued an invoice for $1.5 billion in debt. It was only written off a few years later, during settlements for the Baikonur Cosmodrome."[1]

Islam does not abolish money, it simply does not consider it a commodity, therefore in Islam money is a measure of the value of goods. The production of goods, services and their marketing through entrepreneurship, the use of property or the exchange of it is not considered an act of exploitation, since this occurs in the real sector, i.e. there is a real product, a service that has value and satisfies human needs, and money is an intermediate information link between sale and purchase, and in itself does not satisfy human needs.

5. Shariah Requirements for Murabaha

The essential conditions of Murabaha are the following:

i. Markup: mandatory disclosure of the size of the trade markup and the cost of the product.
ii. Consistency: signing a Murabaha agreement is possible only after the actual purchase of goods by the bank.
iii. Sham transaction: purchasing goods from the Client for subsequent sale to him is prohibited; this operation is also called Bai al inah.
iv. Commodity: The commodity cannot be gold, silver or currency.
v. Price stability: upon signing the contract, the price of the product is fixed and is not subject to further change.
vi. Ownership: ownership of the goods passes to the Client at the moment of signing the contract.
vii. Additional expenses: The Islamic bank is obliged to disclose to the Client the entire list of expenses included in the cost of goods.
viii. Selection of supplier: The Client has the right to specify a specific Supplier.
ix. Disclosure of information: if the Islamic Bank purchased goods from a supplier on terms of installments or deferred payment, then the Islamic Bank is obliged to inform the Client about this.
x. Discount from the supplier: if the Islamic Bank received a discount from the supplier, then the Islamic Bank is obliged to reduce the price for the Client in proportion to the discount received.

And since Murabaha is a trade transaction, in addition to the above conditions, the Murabaha agreement must comply with all the rules of trade prescribed by Shariah:

xi. The product must exist at the time of the transaction;
xii. The seller must be the owner of the goods;
xiii. The goods must be in the possession of the seller;
xiv. The sale is urgent;
xv. The product must have value;
xvi. It is prohibited to sell products of the "Haram" category;
xvii. The product must be clearly known and specifically defined, i.e. You can't sell a "pig in a poke";
xviii. The selling price must be clearly defined;
xix. The delivery date of the goods must be clearly defined and should not depend on uncertain events;
xx. The sale must be unconditional.

6. Conclusion

In conclusion, I would like to say that, despite all those misconceptions, Islamic finance is developing by leaps and bounds all over the world, and in some countries such as Malaysia, the volume of the Islamic finance market is already almost on par with traditional ones. Islamic banks do not invest funds in prohibited activities that do not comply with the principles of morality and ethics. That is, any person who keeps his money on deposit in an Islamic bank can sleep peacefully, without worrying that his money finances the production of weapons, tobacco, alcohol, etc. It is these kinds of advantages, as well as other advantages of Islamic finance, that appeal to more and more people who choose Islamic banks instead of traditional ones.

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