

1 Introduction: Basics of Islamic Finance

1.1 What Is Islamic Finance?

Islamic finance refers to financial activities that comply with Shariah. Shariah is known as Islamic law. The way in which Islamic finance modes are structured is that all transactions will comply with Shariah. If Shariah compliance is compromised, then there will be consequences that the Islamic financial institutions offering Islamic financial services will have to face. The consequences which the Islamic financial institutions will face in this regard include financial consequences, non-financial consequences and statutory consequences. The financial consequences that may arise due to Shariah non-compliance of Islamic financial institutions happen when the Islamic financial institutions are required to give the profits derived from Shariah-non-compliant transactions to charity to purify them. From the Shariah perspective, such profits are given to charity as an act to purify the Shariah non-compliant income received. Non-financial consequences which an Islamic financial institution may face include the reputational risk that may arise due to Shariah-non-compliant events that happen in that institution, adversely affecting the confidence of customers and other stakeholders in the financial products and services offered by Islamic financial institutions. Such reputational damages, which are non-quantifiable, can lead to substantial financial loss of Islamic financial institutions as well. In some countries like Malaysia, Shariah non-compliance of an Islamic financial institution may trigger statutory consequences where the law provides the result of Shariah non-compliance in the form of punishments like stipulating fines and/or imprisonment for the persons in charge. To adhere to Shariah principles within Islamic financial institutions, Shariah governance principles are adopted, such as having a Shariah organ within the Islamic financial institution to advise on Shariah-related matters and having internal Shariah control functions such as Shariah risk management, Shariah review and Shariah audit. Islamic financial products and services are also offered by institutions or companies other than Islamic financial institutions, such as companies offering sukuk (Islamic bonds) in Islamic capital markets. In such instances, the Shariah governance requirements applied and adopted by these institutions or companies are different from those of Islamic financial institutions. Instead of having the Shariah organs established internally and adopting internal Shariah control functions, these institutions are merely required to appoint a Shariah adviser to structure the Shariah-compliant financial instrument and adhere to what is stipulated by the appointed Shariah adviser until the maturity of the financial product. Likewise, for companies who are offering Shariah-compliant stocks, the procedure of Shariah screening is applied to find out their Shariah-compliant status.

Therefore, in a nutshell it can be stated that Islamic finance consists of those commercial transactions that are structured in accordance with Shariah, and Shariah compliance is mandatory in all Islamic finance transactions. Depending on the type of Islamic financial transaction, there are certain Shariah governance standards formulated in the world today that must be adhered to. If not, there are certain consequences that must be faced.

The institutionalization of Islamic finance in modern times began with the inception of the first Islamic bank, Mit Ghamr Savings Bank in Egypt, in 1963. Though the operation of the very first Islamic bank did not last for a long period due to political turmoil in Egypt, in 1975, Dubai Islamic Bank and Islamic Development Bank (IsDB) were established. In terms of institutionalization of takaful, the first takaful (Islamic insurance) company was incorporated in 1979 in Sudan. The first corporate sukuk was issued in 1990 by Shell MDS in Malaysia. Shariah screening of stocks to facilitate Muslim investors was introduced in 1995 by the Securities Commission of Malaysia for listed companies. In 2002, Malaysia pioneered the global sukuk market by launching the first global sukuk, and in 2005, the first Islamic real estate investment trust (i-REIT) was launched in Malaysia. It is imperative to note that Islamic finance in the world has developed gradually, and the development of it varies from one country to another depending on the political will and support given to develop it.

It is believed that the total assets of global Islamic financial services industry are at USD 2.70 trillion in 2020 (IFSB, 2021). In terms of geographical presence of Islamic finance assets, it is found that 48.9 per cent of Islamic financial assets are in the Gulf Cooperation Council (GCC) region, while 24.9 per cent of them are found in the Middle East and South Asian regions; 20.3 per cent of them are found in the South-East Asia region; 1.7 per cent of them are found in the Africa region; and 4.3 per cent of them are found in other regions (IFSB, 2021). Despite the challenges faced by the pandemic, Islamic finance developments are being witnessed in the world, and the potential of Islamic finance to be the alternative financial system to conventional finance system has been realised.

1.2 Differences between Conventional and Islamic Finance

Conventional finance can be described as financial activities that are structured using money as the underlying asset to make profit. Making money out of money is the fundamental way in which conventional financial transactions operate. The typical way in which conventional financial activities are structured is using a loan transaction, where interest is stipulated to capture the time value of money. In this process, simple interest and compound interest can also

be charged. From a Shariah perspective, the issue with conventional finance is that all conventional financing transactions involve *riba*, which is prohibited. In Shariah, a loan contract is known as *qard*, which is supposed to be a benevolent or a gratuitous contract which should only be used to help the parties without charging any amount extra over the principal amount given. If a loan is given, it should be given without making a profit, as it is a contract that is used in Shariah for social purposes only. In a loan transaction, if any amount is stipulated more than the principal amount given, then that extra amount, whether it is stipulated up front or later on, is known as *riba al Jahiliyyah*. There are two types of *riba*: *riba al Jahiliyyah* and *riba al Fadl*. *Riba al Jahiliyyah* is the *riba* known from the Quran that arises when simple or compound interest is charged on a loan. *Riba al Fadl* is known from the Sunnah (tradition of the Prophet (SAW)), where, if the *ribawi* commodities – gold for gold, silver for silver, barley for barley, wheat for wheat, salt for salt and dates for dates – are not exchanged on spot and in the same amount, the delay of time or extra amount exchanged will trigger *riba*.

To avoid the *riba* which is triggered in conventional financing transactions, Muslim scholars attempted to remove the element of *riba* by replacing the loan transaction with *bai'* (sale) transactions. This is because in the Quran it is explicitly stated that Allah (SW) has prohibited *riba* and has permitted *bai'*. Therefore, instead of providing loans with interest and making money out of money, in Islamic finance transactions, *bai'* activities are conducted to generate profit in such a manner that all parties engaging in the transaction share risk between them in a fair manner. However, there are certain fundamental Shariah rules that must be adhered to in conducting *bai'*. Irrespective of the type of *bai'* transaction, in all *bai'* transactions, the parties involved in the transaction must have the legal capacity to enter into the transaction and there should be no element of excessive *gharar* (uncertainty) involved in the transaction. The subject matter of the sale shall be in existence as well as under the ownership and possession of the seller at the time of making of the contract except in two sales: *istisna'* (manufacturing contract) and *salam* (forward sale). Further, no element of *maysir* (gambling) should be allowed in such a transaction, and the subject matter of the transaction must be Shariah-compliant. Apart from these general conditions of *bai'*, there are also specific conditions that would be applied in conducting specific sale transactions.

In Islamic finance, there are various Shariah-compliant contracts used to structure the financial transactions. These include sale contracts, lease contracts, partnership contracts and service contracts. In addition to these types of contracts, there are also security contracts which are used to secure the future debt obligations. In short, it can be said that in Islamic finance transactions, the way the parties engaged in the transaction receive profit is by receiving the price of

sale of an asset, by receiving the rent for a leased property, by receiving wages for a service provided, or by receiving profit by entering into a partnership to engage in a Shariah-compliant activity. This simply means that in Islamic finance transactions using money, first an underlying asset is purchased or a real economic activity is engaged to make profit. There is no situation in Islamic finance transactions where a loan is given to make profit by charging interest. However, an interest-free loan can be given. Table 1 illustrates the most common Shariah-compliant contracts used to structure Islamic finance transactions with the Shariah parameters that ought to be followed in using them.

1.3 Principles of Islamic Finance

There are certain principles of Islamic finance that need to be followed in all types of Islamic financial transactions. Apart from the principles of Islamic finance mentioned in the following sections, the prohibition against using Shariah non-compliant assets and activities and the allowing of use of Shariah-compliant commercial contracts to structure Islamic finance products and services are also some of the important principles adhered in Islamic finance.

1.3.1 Elimination of Riba

Riba literally means increase or excess. There are four stages found in the Quran for prohibition of riba. The first stage is found in Surah 30:39 of the Quran, where it is stated that riba transactions will have no blessings from Allah (SW), while the second stage is found in Surah 4:161 of the Quran, where it is stated that taking riba is equivalent to eating of wealth unlawfully. The third stage is found in Surah 3:130 of the Quran, where it is asked that believers not devour usury doubled and multiplied and to fear Allah (SW); and the final stage is found in Surah 2:275 of the Quran, where it is expressly stated that Allah (SW) has forbidden riba while stating that trading is permitted. There are two types of riba, and these types are shown in Table 2.

1.3.2 Elimination of Excessive Gharar

Gharar is uncertainty, and excessive uncertainty (Gharar Fahishah) needs to be eliminated in all Islamic finance transactions. This is the general rule applied to Islamic finance transactions. However, there are two exceptional sale contracts in Shariah, Salam and istisna' contracts, where the sale could be concluded even though the subject matter is not in existence at the time of the sale. There is no specific mention of the word gharar in the Quran; however, jurists have considered gharar with the practice of vanity (al

Table 1 Most common Shariah-compliant contracts used to structure Islamic

Shariah-Compliant Contract	Nature	Description
Murabahah (cost plus profit sale)	Sale	Murabahah is a trust sale. Therefore, its acquisition price of the asset sold, and the profit, are disclosed to the buyer. Further, in most cases, Murabahah is a spot sale, to suit the needs of the buyer. It can also be structured as a deferred sale. Therefore, the time of sale, and the duration of the sale, for the period must be agreed upon.
Bai' Muajjal (Deferred sale)	Sale	Bai' Muajjal is a deferred sale, also known as Bai' Taqdit, where the price of the asset is paid at a later date. It involves two parties, with the period of deferred sale and the frequency of payment.
Tawarruq (Monetization or tripartite sale)	Sale	Tawarruq is a sale transaction where the asset is sold on a cash basis to a party who needs cash; who then immediately sells it to a third party on the spot. In this transaction, there are three parties involved and the conditions of the second transaction are based on the first transaction.

Table 1 (cont.)

Shariah-Compliant Contract	Nature	Description
Salam (Forward sale)	Sale (Exceptional)	Salam is a forward sale which can only be used for goods where the subject matter of sale is fungible goods such as stones. In entering into a salam contract, the price with price must be determined at the time of the contract. It is mandatory to pay the price of the goods at the time of the contract. The date of delivery must be specified. The goods sold in the market is also a requirement.
Istisna' (Manufacturing contract)	Sale (Exceptional)	Istisna' is a manufacturing contract where the manufacturer provides the goods and the buyer provides the specification. The price of the goods will be determined at the time of the contract. In a Salam contract, in an istisna' contract, the parties must decide the way in which they intend to manufacture the goods. The price will be fixed. To qualify for an istisna' contract, the manufacturer shall provide both the raw materials and the labor.
Ijarah (Lease)	Lease	Ijarah is a leasing contract where an asset is hired for a period. It can be hired to obtain a service for a period. The asset is leased, as the subject matter will be specified in a sale contract, in a leasing contract, or in a hire contract.

Mudharabah (Money management partnership) Equity

Musharakah (Partnership) Equity

transfer from lessor to lessee; but it that will be transferred for an agree lease period, the leased asset will be case should be the owner of the ass authority to lease the asset. In a lease period including the frequency of re parties, and the operational cost rela the lessor. The liability for the lessee when he/she is given the asset by th

Mudharabah is a money management gives capital and the other party ag compliant business. They will agree no amount of profit or capital can b case of negligence, all the financial provider, whereas the non-financial partner.

Musharakah is a partnership contract decide what they would like to contr and/or reputation). However, they ha ratio, and no amount of profit or cap loss will depend on the capital cont

Table 1 (cont.)

Shariah-Compliant Contract	Nature	Description
Wakalah (Agency)	Service	Wakalah is an agency contract where the agent is provided as an agent. The service of the agent is provided. However, if such a service is provided, it is a binding contract. In this contract, the terms and conditions by the principal shall be clear and the agent should act for the principal. The agent should not act in the interest of the principal and should act as a trustee of the principal. If given, the fee must be clear to both parties and in any manner the parties consent.

Table 2 Types of riba

Type	Explanation
Riba al Jahiliyya	Riba al Jahiliyyah is also known as riba known from the Quran. Another name for it is riba al Jahiliyyah (which means the riba that arises from a loan transaction). This type of riba is stipulated in a loan contract to be paid on top of the principal payment. The stipulation of an extra amount over the principal amount in a loan contract or stipulation of an extra amount due to the loan trigger this type of riba. Further, in these circumstances, this type of riba is significant or insignificant amount over the principal amount of the loan is significant or insignificant.
Riba al Fadl	Riba al Fadl is also known as riba known from Sunnah. Another name for it is riba al Fadl (which means the riba that arises from exchange of ribawi commodities, which are not measured by weight or salt). The following hadith establish the rules of riba al Fadl: ‘It was narrated that Muslim bin Yasar and ‘Abdullah bin ‘Atik said: “Ubadah bin As-Samit and Muawiyah met at a stopping place on the road and they said: ‘Allah forbade selling gold for gold, silver for silver, wheat for wheat, barley for barley, but they said: ‘salt for salt’, but the other did not say it - ‘unless it was like for like, or us to sell gold for silver and silver for gold, and wheat for barley and barley for wheat, if you wanted.’ And one of them said: ‘Whoever gives more or asks for more than what he gave or asked for, it is riba.’ (4560). From the above hadith, there are two types of goods that are found based on the above hadith which are used as medium of exchange; and wheat, barley, dates and sa

batil), which is found in Surah 2:188 and 4:161 of the Quran (Al-Saati, 2003). There are various hadith that prohibit excessive gharar in sale contracts, and the reason for such a prohibition is to protect both parties entering into a sale transaction from dealing with uncertainty that may cause harm and unfairness to them. For instance, it is stated in hadith that the sale of fish in the sea or of a flying bird, the sale of an unborn calf in its mother's womb and the sale of runaway slaves or animals are prohibited. If such a transaction is entered, there is no guarantee that the seller will be able to obtain the goods and fulfil his obligation under the sale contract to deliver the asset to the buyer. As such, in Islamic finance transactions, except for salam and istisna' contracts, the subject matter shall exist at the time of the sale and it must be capable of delivery. Further, the subject matter shall be owned by the seller and must be under his/her possession at the time of the sale. If the seller is not the owner, he/she must have the legal authority to conduct the sale transaction on behalf of the owner of the asset. In a sale transaction, gharar shall be avoided not only with relation to subject matter, but it shall be voided in type and/or attribute and/or quantity of the subject matter, delivery time of the asset, price, mode of payment and frequency and duration of payment in instalment sales. The effect of a sale with gharar is that existence of excessive gharar will make the contract null and void.

1.3.3 Elimination of Maysir

Maysir is gambling, and all forms of activities that are considered to be gambling are prohibited in all Islamic finance transactions. To identify a transaction as gambling, from a general perspective, there are three requirements that shall be present concurrently in a transaction: firstly, all parties involved in the transaction shall contribute financially; secondly, the party who will gain in the transaction will be determined using luck; and finally, one party gaining in that transaction will make all the other parties lose the financial amount they have contributed. If the modus operandi of a transaction is structured in such a manner, then the element of gambling will exist in it, making the transaction invalid from the Shariah perspective. Maysir is also an excessive gharar. Surah 5:90 of the Quran explicitly prohibits engaging in maysir.

1.3.4 Elimination of Dhulm

Dhulm is injustice. In all kinds of Islamic finance transactions, anything that leads to injustice or oppression shall be avoided. This should be the case even if the parties have given consent to enter into the transaction. The aim of