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Principles and Products of Islamic Finance

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1 Principles of Islamic finance

The principles of Islamic finance are laid down in the sharia, Islamic law. Islamic finance, comprising financial transactions in banks and non-bank financial institutions formal and non-formal financial institutions, is based on the concept of a social order of brotherhood and solidarity. The participants in banking transactions are considered business partners who jointly bear the risks and profits. Islamic financial instruments and products are equity-oriented and based on various forms of profit and loss sharing. As Islamic banks and their clients are partners, both sides of financial intermediation are based on sharing risks and gains: the transfer of funds from clients to the bank (*depositing*) is based on revenue-sharing and usually calculated ex post on a monthly basis[1]; the transfer of funds from the bank to the clients is based on profit-sharing (*lending, financing*), either at a mutually agreed-upon ratio as in the case of mudarabah or at a mutually agreed-upon fixed rate. Such ratios and rates vary between institutions and may also vary between contracts within the same institution, contingent upon perceived business prospects and risks. Islamic banking finances only real transactions with underlying assets; speculative investments such as margin trading and derivatives transactions are excluded. Lending, or financing, is backed by collateral; collateral-free lending would normally be considered as containing a speculative element, or moral hazard. Similarly, to avoid speculation and moral hazard, normally only investors with several years of successfully business experience are financed. The paying or taking of *riba,* interest, is prohibited.

The same principle of partnership is applied to Islamic insurance. It is based on a collective sharing of risk by a group of individuals whose payments are akin to premiums invested by the Islamic banking institution in a mudarabah arrangement for the benefit of the group.

The fundamental principle of solidarity at the societal level finds its expression in a special category of financial products without remuneration, *qard*. Investors without adequate business experience who are considered high-risk may receive a moderate amount of financing on qard hasan terms, free of any profit-sharing margin, but usually repaid by instalments and backed by collateral. Similarly (but rarely in Indonesia), depositors may save in an Islamic financial institution without receiving a remuneration, usually with the expectation that the funds are used for social or religious purposes. In inflationary economies, qard deposits and financings pose unresolved problems.

Bank Indonesia (2002:16) has provided the following vision & mission of sharia banking development in Indonesia:

> "A sound sharia banking system that is competitive, efficient and compliant with prudential practices, and capable of supporting real economic sector through the implementation of share based financing and trades with real underlying transactions in the spirit of brotherhood and good deeds to promote well-being for all society."

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[1] In one sense, depositors are treated like shareholders; in another sense, they are treated better than shareholders, as they share in the revenue and not the profit.

2 Typology of Islamic financial institutions in Indonesia

Islamic finance is defined as a financial system based on Islamic law, شريعة , variously transcribed as shar'iah, sharia or Syariah. In Indonesia, Islamic finance is referred to as sharia finance when addressed to a wider audience (as in central bank publications) or Syariah finance when addressed to a predominantly Islamic audience. In this study, both terms are used. At national and institutional levels, Islamic finance is supervised by sharia supervisory boards (SSB).

Islamic finance in Indonesia comprises two types of institutions: (i) banking institutions, which fall under the banking law, and (ii) financial cooperatives. There are three types of Islamic banking institutions, of which the first two fall into the legal category of commercial banks:

- Full-fledged Islamic commercial banks: Bank Umum Syariah (BUS)
- Islamic banking units of commercial banks: Unit Usaha Syariah (UUS)
- Islamic rural banks: Bank Perkreditan Rakyat Syariah (BPRS)

The Indonesian banking law recognizes two types of banking institutions: commercial banks and rural banks (BPR), with widely differing minimal capital requirements. The Islamic commercial banks and commercial banking units are a subcategory of the commercial banks, the Islamic rural banks (BPRS) a subcategory of the rural banks (BPR). The subcategories are included in the respective banking statistics of the central bank.

The Islamic financial cooperatives in Indonesia are not part of the formal financial sector. They may be registered with the Ministry of Cooperatives or be unregistered; accordingly, they may be placed into the semiformal and the informal financial sector, respectively. As they are not formally regulated, the distinction is of limited relevance. Initiated by a group of Muslim intellectuals and promoted by PINBUK, they are generally referred to as BMT as a generic term. Their development has been favored by the Muslim organizations Nadhatul Ulama and Muhamadiyah, but were not established by them. Since 1999 when Muhamadiyah began to provide guidance and supervision through its Pusat Pengembangan Ekonomi Muhammadiyah (PPEM), it created a new term for the cooperatives under its influence, BTM. In Aceh, yet another term is being used: Baitul Qirad.

- BMT Baitul Maal wat Tamwil, comprising about 95% of Islamic cooperatives, with affinity to Nadhatul Ulama (NU), with almost 40m members the largest Islamic mass organization in Indonesia; however, NU does not play an active role in guiding and supervising BMT. Most of these are supposed to be under the guidance of PINBUK; statistics on BMT usually include the BTM (unless otherwise stated).
- BTM Baitul Tamwil Muhamadiyah, comprising about 5% of Islamic cooperatives, guided since 1999 by Muhamadiyah, with some 25 million members the second-largest Islamic mass organization in Indonesia. BTM are informally supervised by PPEM.
- BQ Baitul Qirad, a term used in the province of Aceh to connotate Islamic cooperatives.

BMT reportedly have a mixed commercial and social orientation, while BTM have a more definite commercial orientation.

3 Typology of Islamic financial products

(1) Financing products

Profit sharing financing products:	
Musharakah Musyarakah **مشاركة**	Equity participation, investment and management from all partners; profits are shared according to a pre-agreed ratio, losses according to equity contributions.
Mudarabah **مضاربة**	A profit-sharing partnership to which one contributes the capital and the other the entrepreneurship; or the bank provides the capital, the customer manages the project. Profit is shared according to a pre-agreed ratio
Qard Hasan Qard al-Hasanah **حسن**	Charitable loans free of interest and profit-sharing margins, repayment by instalments.A modest service charge is permissible
Wakalah **وكالة**	An authorization to the bank to conduct some business on the customer's behalf
Hawalah **حوالة**	An agreement by the bank to undertake some of the liabilities of the customer for which the bank receives a fee. When the liabilities mature the customer pays back the bank
Advance purchase financing products:	
Murabahah مرابحة	A sales contract between a bank and its customers, mostly for trade financing. The bank purchases goods ordered by the customer; the customer pays the original price plus a profit margin agreed upon by the two parties. Repayment by installments within a specified period
Istithna' **إستثناء**	A sales contract between bank and customer where the customer specifies goods to be made or shipped, which the bank then sells to the customer according to a pre-agreed arrangement. Prices and instalment schedules are mutually agreed upon in advance.
Mu'ajjal Bai al Salam بيع مؤجل	Purchase with deferred delivery: A sales contract where the price is paid in advance by the bank and the goods are delivered later by the customer to a designee
Ajaar Ijarah Ijarah Mutahia Bittamlik آجا	Lease and Hire Purchase: A contract under which the bank leases equipment to a customer for a rental fee; at the end of the lease period the customer will buy the equipment at an agreed price minus the rental fees already paid.

(2) Deposit products

Wadi'ah وديعة	Deposits, including current accounts (*giro wadi'ah*)
Mudarabah **مضاربة**	Deposit products based on revenue-sharing between depositor and bank, including savings products withdrawable at any time and time deposit products
Qard al-Hasanah	Unremunerated deposit products, usually for charitable purposes (*widespread in Iran, but not found in Indonesia*)

(3) Insurance products

Tadamun, Takaful تضلمن - تكافل	Islamic insurance with joint risk-sharing

(4) Selected Islamic banking terminology

Baitul Qirad بيت الإقراض	Islamic cooperatives cooperatives in Aceh, Indonesia *Lit.:* house of loans
Kafil كفيل	Guarantor
Infaq إنفلق	Expenditure
Mudharib مضارب	The project in a mudarabah contract
Shirkah مشاركة - شركة	Partnership
Rahn رهن	Collateral agreement
Sadaqaat صدقات	
Sharia Shar'iah, Syariah ع شريعة	Islamic law
Shirakah fi al-uqood شراكة في العقود	Voluntary contractual agreement for joint investment and the sharing of profits and risks.
Takaful تضلمن	Solidarity, mutual support as the basis of insurance
Wakil وكيل	Agent
Zakat زكاة	Obligatory charity, Islamic tax