



## 2007

### ISLAMIC FINANCE LAW – PART 1

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An Introduction to  
Islamic Finance Law 1

#### ABOUT NANYANG LAW LLC

We are a dynamic, innovative and vibrant boutique Singapore law firm. We are fully committed to providing the highest quality legal services to our clients and ensuring our clients have easy access to our professional staff.

We specialize in a variety of work such as corporate, intellectual property, chancery, litigation and corporate secretarial services.

As a result, our clients range from public listed companies to venture capital firms to individuals with specific needs.

We will be happy to meet you to discuss your needs and see how best your interests can be protected. We take this opportunity to reiterate our vision statement which is to provide quality and timely legal services, which adhere to the highest standards of integrity and excellence, delivered in a professional, responsible and client-oriented manner.

We look forward to being of assistance to you.

#### FOREWORD

Dear friends, partners and clients,

Merry Christmas and warmest greetings to you!

We hope you enjoyed reading our 4th issue of Law @ Nanyang in October 2007.

For the 5th issue, we introduce on the basic concept of Islamic Finance Law.

We further hope you will find this issue informative. Please do not hesitate to contact us if you have any queries relating to this newsletter.

Happy reading!

**Ng Kim Tean**  
Managing Director

#### ISLAMIC FINANCE LAW – PART I

The first part introduces the reader to the basic concept of Islamic Finance Law. Subsequent parts will lay out some of the more common Islamic Finance products and legal issues which may arise in relation to Islamic Finance products.

#### A SHORT HISTORY OF ISLAMIC BANKING<sup>1</sup>

Islamic Finance has existed since the time of the Prophet Muhammad (s.a.w.).

However, the first experiments in modern Islamic Finance started in Egypt in 1963. At that time, modern Islamic banking was implemented under a cloud of secrecy for fear that it would cause a spread of Islamic fundamentalism. However, such fear did not stop the expansion of Islamic banking in Egypt and by 1970, there were nine such institutions there. In 1971, Nasir Social Bank was established in Egypt and declared as an interest free commercial bank, but no reference to Islam or Syariah (Islamic Law) was made.

With the subsequent change in the political climate of many Muslim countries resulting in there being no longer any need to establish Islamic banking institutions under cover of secrecy, the 70s and 80s saw a prolific increase in Islamic banking in the Middle East.

The growth of Islamic banking was not limited to the Middle East. In the Asia Pacific region, Philippine Amanah Bank ('PAB') was established in 1973 via a Presidential Decree as a specialized banking institution without reference to its Islamic character in the bank's charter.

Islamic banking made its official debut in Malaysia in 1983. Historically speaking, in 1963 an institution had been established under Islamic law to enable Muslims in Malaysia to save for their Haj. This institution still exists and now is known commonly as the 'Tabung Haji'.

CIMB Bank, as an example, now has a comprehensive slew of Islamic law compliant products, not only for the individuals, but also for companies and international trade.

<sup>1</sup> Extracted mostly from *ISLAMIC BANKING* by Mohamed Ariff, University of Malaya, taken from *Asian-Pacific Economic Literature*, Vol. 2, No. 2 (Sept 1988), pp. 46-62

In Singapore, Islamic banking has been actively promoted with at least two local banks (Oversea-Chinese Banking Corporation Ltd ('OCBC') and Malayan Banking Bhd ('Maybank')) offering Islamic banking products, mostly catering to individual consumers.

OCBC had also recently introduced their OCBC **Treasury Mudharabah Account (OTMA)**, a new Syariah approved product that is based on the concept of 'Mudharabah' or 'profit sharing'.

The Singapore government, having firmly established Singapore as a financial hub, has been actively forging ahead to make Singapore an Islamic Financial Hub.<sup>2</sup> Unfortunately, the unwillingness by the Monetary Authority of Singapore ('MAS') to develop a separate regime for Islamic banking may limit the development of Islamic banking in Singapore.

International banks have also joined the foray into Islamic banking. Hong Kong & Shanghai Banking Corporation ('HSBC'), Deutsche Bank, and Standard Chartered Bank, amongst others, have established Islamic banking arms to cater to the market.

As recent as in May 2007, the world's first Islamic subordinated 'sukuk'<sup>3</sup> to qualify as bank regulatory capital was launched.

It is abundantly clear that Islamic banking and finance is here to stay.

## THE SOURCE OF ISLAMIC FINANCE LAW

Islamic law is made up of commands found in the Quran read together with the teachings of the Prophet (s.a.w.).

Islamic law covering marriages and succession is commonly recognised and enforced in various courts of law. However, what is also known is that Islamic law also covers finance and this forms the basis of Islamic Finance law.

## THE BASIC TENETS OF ISLAMIC FINANCE LAW

The best known feature of Islamic Finance law is the prohibition on interest. Islam specifically forbids the charging of interest ('riba' in Arabic) on money lent. The general consensus among Muslim scholars is that riba is not restricted to usury but encompasses interest as well. Any fixed or guaranteed interest on payment on cash advances or on deposits are similarly prohibited.



### **RULE 1: Any predetermined payment over and above the actual amount of principal is prohibited.**

Islam allows only one kind of loan, 'qard-el-hassan' (literally meaning 'good loan'). Here, the lender does not charge any interest or additional amount over the money lent. Muslim jurists have construed this principle so strictly that any associated or indirect benefits are prohibited.

In strict terms, a lender cannot even accept food, transport or other benefits from the borrower as a result of him granting the loan.

### **RULE 2: The lender must share in the profits or losses arising out of the enterprise for which the money was lent.**

Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. Islamic finance is premised on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whatever it may be.

In Islamic banking, the depositor, the bank and the borrower would all share the risks and the rewards of financing business ventures. This is unlike the commercial banking system where all the pressure is on the borrower to pay back the loan and agreed interest, regardless of the success or failure of the venture.

Islam recognises that investments will stimulate the economy and will eventually benefit the community and that with higher risks would often result in higher returns. Investments that have higher risks would also encourage entrepreneurs to maximise their efforts, thus ensuring that minds do not remain idle.

<sup>2</sup> Establishing Singapore as an Islamic Financial Hub, 21 – 22 February 2006, Grand Copthorne Waterfront, Singapore

<sup>3</sup> 'Sukuk' is an Arabic word which means 'legal instrument, deed, check'



Islam frowns on those who does not wish to invest but instead keeps their funds in banks and receive interest for the funds, running virtually no risk (other than the risk that the bank becoming insolvent). The prohibition of riba thus serves the purpose of ensuring that those who does not wish to invest would instead suffer loss through devaluation of their funds by inflation.

**RULE 3: Making money from money is not 'Islamically' acceptable.**

In Islam, money is only a medium of exchange, a way of defining the value of a thing. Money, according to Islam, has no value in itself and therefore should not be allowed to give rise to more money. This is the reason for strict prohibition of riba.

Islam believes that human effort, initiative and risk in a venture is more important than the money used to finance the venture.

Muslims are encouraged to purchase and are discouraged from keeping money idle. In Islam, money represents purchasing power, nothing more. Thus, in order to increase money, Islam requires that it undergoes the intermediate step of being used for the purchase of goods and services.

**RULE 4: 'Gharar' is also prohibited.**

The Arabic word 'gharar' means risk, uncertainty and hazard. Unlike riba, gharar is not precisely defined. Gharar is also considered to be of lesser significance than riba, for no venture can be carried out without gharar at all.

Thus, whilst the prohibition of riba is absolute, some degree of gharar or uncertainty is acceptable in transactions under Islamic Law. Only conditions of excessive gharar need to be avoided.

Gharar has been defined by the Hanafi jurist al-Sarakhsi as any bargain in which the result of it is hidden. This concept is similar to the common law concept of misrepresentation, or the more serious act of fraud. The need for this prohibition comes from the wish to protect the weak from exploitation.

**RULE 5: Investments should only support practices or products that are not forbidden.**

Islam has specific rules as to what is 'halal' (i.e. permitted) and 'haram' (i.e. forbidden). In certain circumstances, certain 'haram' acts can be 'makroh' (i.e. permissible, but best not done).

Islam prohibits investment in anything that is illegal (i.e. 'haram'). As such, financing for casinos, and manufacturing of alcohol and alcohol-related products or trading in alcohol are all not allowed. Islam also prohibits the lending by one bank to another at an interest (i.e. prohibition against riba).

All banks having an Islamic Finance arm would have a group of Islamic scholars who would advise the bank on all new financial products and schemes. This would ensure that the basic tenets of Islamic Finance are not breached.

In the next issue, we will cover on some of the Islamic Finance products available in the market.



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