A Beginner’s Guide to

Shariah Compliant Investing
This document contains excerpts from the Holy Qur’ān and words spoken by the Holy Prophet (Peace be Upon Him) and therefore should be handled with due care and respect.
Contents

1 Pronunciation .......................................................... 3
2 Introduction ............................................................... 4
3 Islam ........................................................................ 5
4 Islamic Law: Shari’ah and Fiqh .................................... 6
5 The Four Schools of Islamic Law .................................... 7
6 Key Principles in Islamic Finance ................................... 9
7 Shari’ah Supervisory Board .......................................... 12
8 Law of Contracts ........................................................ 14
9 The Islamic Financial Intermediation Process .................. 15
10 Milestones in Modern Islamic Finance ......................... 17
11 The Shari’ah Alternative to Conventional Money Market and Fixed Income Products .......... 19
12 Shari’ah Compliant Equities ....................................... 23
13 Setting Global Standards in Islamic Finance ................. 26
14 Glossary .................................................................. 27
15 Bibliography ............................................................. 29
<table>
<thead>
<tr>
<th>Arabic</th>
<th>English</th>
<th>Key to pronunciation</th>
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<tbody>
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The Shari’ah compliant funds industry is defined by significant innovation and product development. The outlook for this industry is optimistic and is supported by strong demographics. While total assets under management in registered Islamic funds is approximately at $60.2 billion, the industry is poised to witness a 5.5% annual growth rate over the next 5 years. While Islamic funds remain a fraction of the overall Islamic finance market (a market with an estimated size of $2.4 trillion, experiencing circa 17% compounded annual growth since 2009), significant innovation has happened over the recent past within this subsector of the overall industry which can be witnessed in the breakdown of assets under management within Islamic funds. While Islamic funds were traditionally dominated by equity product offerings (making up in excess of 50% of total assets in 2013), this has become significantly more diversified with increased penetration from Sukuk funds as the asset class has gained in popularity attracting strong growth in assets and attracting new participants to the Islamic finance market. Real estate Islamic products as well as commodity funds have also experienced growth. New areas of innovation and focus include Islamic alternative funds and strategies such as hedge funds as the industry continues to evolve and bridge the gap between conventional and Islamic capital markets. While the majority of the focus has been on the quantum of growth witnessed in the size of the industry to date, future efforts are likely to be focused on the “quality” of the growth i.e. diversifying away from traditional sources of growth such as equity or Sukuk funds as an asset class and the GCC or South East Asia with regards to a geographical focus. The Islamic asset management industry ultimately remains a highly fragmented industry with around 1200 individual funds registered making up the approximately $60.2 billion industry size. As the industry reaches some level of critical mass, one expects some consolidation to occur.

Perhaps the area of Shari’ah compliant finance which has received the most attention through rapid growth and innovation has been the global Sukuk market. With a compounded annual growth rate of 23% between 2000 and 2015 bringing the industry to a total size of $345 billion in outstanding debt, we continue to witness the ongoing evolution of the sector which has attracted investors beyond the traditional borders of the GCC and South East Asia as the pool of assets has grown and markets have continued to improve with regards to depth and liquidity. Innovations such as the first ever perpetual Sukuk, an increased number and spread of corporates tapping the global Sukuk market, the ongoing development of secondary trading markets for these instruments and attractive structures continue to drive interest in this space. With regards to African interest in the Sukuk space, Nigeria and Kenya are poised to join the likes of South Africa, Ivory Coast and Senegal in tapping this ever developing pool of funding.

Notwithstanding the already robust growth and efforts made with regards to innovation in the Islamic finance space, significant tailwinds continue to exist which is likely to drive increasing innovation and development as the economics makes sense and becomes lucrative. With approximately 1.8 billion Muslim people currently in the world and this number set to grow to 2.6 billion by the year 2050, constituting some 30% of the approximated global population by this date, the demand for Islamic financial services particularly those outside of banking is likely to continue on such a growth trajectory into the long term. In addition to sheer population growth, the number of middle class citizens in the Muslim populous countries of Egypt, India, Indonesia, Malaysia, Pakistan, Saudi Arabia and Turkey are set to grow to 404 million people by 2050. This is merely in addition to an already wealthy GCC majority Muslim population and improving Muslim demographics across the globe. In addition to positive demographic developments, capital markets in the Shari’ah compliant sphere are poised to deepen substantially as pension industries in Muslim populous regions evolve with Earnst & Young estimating unaddressed global demand for Shari’ah compliant pension solutions at between $160 billion and $190 billion.

1. Malaysia International Islamic Financial Centre: 2015 Review and Outlook
2. Franklin Templeton Investments / Malaysia Islamic Financial Centre
3. Thomson Reuters Global Islamic Asset Management Outlook 2015
4. Bloomberg LP/ Franklin Templeton Investments
5. Fleishman-Hillard Majlis
6. UN, World Bank, HSBC “US$5 000-25 000”
The Prophet (PBUH) said: “Islam is based on five (pillars); testifying that there is none worthy of worship besides Allāh (one Lord) and that Muḥammad is the Messenger of Allāh, establishing Salāh (prayer), discharging Zakāh (obligatory charity), performing Ḥajj (pilgrimage) and fasting in Ramaḍān (name of Islamic month).” (‘Al-Bukārī, ‘al-Muslim)

What is Islam?

Islam is:

• The voluntary submission of ones will to the decree of God, Allāh.
• A complete code covering every aspect of life and not only restricted to acts of worship.
• Derived from the root word meaning ‘Peace’.
• The final revealed guidance from the Creator of mankind.
• A Muslim is one who adheres to Islam and believes in its teachings.

The five pillars of Islam

1. Shahādah: the declaration of faith that there is no God but Allāh and Muḥammad (PBUH) is the messenger of Allāh.
2. Ṣalāh: performing the five daily prayers.
3. Zakāh: discharging 2.5% of specific wealth (for example, cash, trading stock, etc.) annually to the poor.
4. Ṣawm: fasting during the days of the month of Ramaḍān (9th month of the Islamic calendar).
5. Ḥajj: pilgrimage to Makkah once during one’s lifetime, only if one can afford the journey both physically and financially.

Basic beliefs of Muslims

• That there is only one God, Allāh, who has no child, partner or equal.
• That Muḥammad (PBUH) is the final Messenger and Prophet of Allāh.

Islam in practice

Islam is considered a complete code of life - covering all aspects of a Muslim’s life. In practice, Islam can be divided into five distinct categories. These are:

1. ‘Aqā’id - beliefs
2. ʿIbādāt - worship
3. Mu‘āsharāt - social activities
4. Akhlāqiyyāt - character, morals and ethics
5. Mu‘āmalāt - dealings with others, including economic and financial dealings
The Prophet (PBUH) said: “Searching for lawful sustenance is an obligation after (the necessary) obligation.” (‘Al-Ṭabrānī, ‘al-Baihaqī)

What is the meaning of Shari’ah and Fiqh?

The literal meaning of Shari’ah is a ‘water source’. Technically it refers to the body of Islamic Law that regulates the day-to-day life of Muslims. Shari’ah relates to many aspects of Muslim life, including worship, politics, marriage, divorce, business dealings, inheritance, death and burial.

The literal meaning of Fiqh is ‘deep insight’ Technically Fiqh or Islamic Jurisprudence is the understanding of the detail and individual rulings of Islamic Shari’ah Law. Islamic Law is based directly on the Qur’ān and the Sunnah, as interpreted by Muslim scholars, generally referred to as Muslim jurists.

Sources of Shari’ah and Fiqh

The rules of Shari’ah and Fiqh are derived from the following four sources, with the Qur’ān and the Sunnah being the primary sources of Shari’ah Law.

1. The Qur’ān, which is the revealed word of God.
2. Sunnah, which is the recorded words, practices and tacit approval of the final messenger, Muḥammad (PBUH). Sunnah is commonly termed as traditions of the Prophet (PBUH).
3. Ijmā’, which is the consensus of Muslim scholars on a specific ruling. When there is no explicit mention of a specific ruling in the Qur’ān or Sunnah, Muslim scholars apply their minds to deduce a ruling based on their understanding of the Qur’ān and Sunnah. Ijmā’ is generally referred to as “the consensus of the companions of the Prophet (PBUH)” or early day Muslim scholars. Contemporary scholars also unanimously rule on matters, which is also referred to as Ijmā’.
4. Qiyās, which is analogy drawn rulings based on the correct principles of Shari’ah. This refers to a Muslim scholar drawing on analogy or a parallel between something that the Qur’ān and the Sunnah had specifically mentioned and something else that had not been mentioned, if there was common ground between them.
The Prophet (PBUH) said: “A time will come upon the people when a person will be indifferent as to what he takes (earns), whether it is from the lawful or the forbidden.” (‘Al-Bukhārī, ‘al-Nasā’ī)

The four sources of Shari’ah law have been applied by Muslim scholars from the time of the demise of the Holy Prophet (PBUH). Four schools of thought emerged over the last 1400 years. Each school reflects the dominant ideas and opinions of its founder, i.e. his understanding of the sources of Shari’ah law.

The four schools of thought in Islamic Jurisprudence are:

1. Ḥanafī: named after the Iraqi scholar ‘Abū Ḥanīfa ʿan-Nu‘mān ‘ibn Thābit (699-767 CE), whose views were recorded by two of his students, ‘Abū Yusuf and Muḥammad ‘al-Shaibānī.


4. Ḥanbalī: named after ‘Aḥmad ʿibn Muḥammad ʿibn Ḥanbal (780-850 CE). He compiled a collection of traditions called the Musnad, which became a source for understanding his juristic rulings.

All schools rank equal and do not differ on the fundamental principles of Islam. The differences occur in the application and branches of law rather than in the principles, thus ensuring conformity. In practice, jurists from the four schools derive rulings and edicts from their respective schools of thought. However, it is also common practice for jurists to draw on rulings from any of the other schools.
Praise Allah
The Prophet (PBUH) said: “The honest, trustworthy trader will be with the messengers, the truthful and the martyrs.” (‘Al-Tirmiẓī)

The rulings by Islamic jurists are based on a number of fundamental Islamic principles. These principles form the foundation within Islamic finance and need to be understood before one can understand the structure of Islamic financial services and products. We review some of these important principles below.

The foundations of Islamic finance

a) Ribā (interest) is prohibited in all transactions.
b) Transactions should be free from Gharar (speculation or unreasonable uncertainty).
c) Business and investments are undertaken on the basis of Ḥalāl (permissible) activities.
d) Investments should be based on profit and loss sharing.
e) Transactions should be asset-backed.

All activities conducted by financial institutions offering Shari’ah compliant financial services and products must be aligned to Islamic principles, with a special Shari’ah Supervisory Board (SSB) appointed to oversee and advise the financial institution on the propriety of transactions.

These principles make Islamic financial services unique and are discussed in detail below:

a) Ribā

Ribā is translated as interest and literally means ‘increase’ or ‘excess’. It is technically an advantage to one party at the expense of the other for no appropriate consideration. Ribā is totally and completely prohibited in Islam. The Qur’ān says, ‘And Allāh has permitted trade and has forbidden interest’. (Chapter 2, Verse 275)

There are two types of Ribā:

1. Ribā al-Nasiah is interest on a loan, where a borrower is subject to paying extra, over and above the amount borrowed. The lender is ‘charging’ for the period of the loan offered to the borrower. This type of Ribā is forbidden in the Qur’ān (Chapter 2, Verse 275; Chapter 3, Verses 130 & 131). Many reasons have been cited for the prohibition of Ribā, amongst them:
   - Allāh, the All Wise, has forbidden it (the most important reason).
   - It is unjust, as one party assumes all the risk and the other enjoys a fixed return.
   - It leads to the concentration of wealth amongst the rich.

2. Ribā al-Faḍl relates to the exchange of specific items that have to be equal when swapped, and the simultaneous possession of both counter values must take place at the time of concluding the transaction. Any surplus at the time of exchange, or delay in possession of one or both counter values will result in Ribā (interest). The source of this ruling is a tradition of the Prophet (PBUH):

   It is reported that the Prophet (PBUH) said: “gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal, hand-to-hand, if the merchandise differs, then you may sell as you wish provided the exchange is hand-to-hand.” (‘Al-Muslim)

   Muslim scholars have discussed this tradition in great detail and concluded that this type of Ribā extends to a wide range of items. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAO-IFI) has included the sale of currencies in this tradition.
b) Gharar

Gharar is translated as ‘uncertainty’. Technically it is the lack of knowledge or uncertainty that could lead to an undesirable outcome for a party. The existence of such uncertainty renders a Shari’ah contract invalid. An example of Gharar is the prior sale of fish whilst still in the water, as the type, weight and possibility of delivery is unknown. Another example is a futures contract, on agreement reached between two parties; a sale is concluded at the outset for delivery on a future date on some underlying asset. However, like the fish in the ocean, one is unaware of whether such an asset will be in existence at the future delivery date. Another example is conventional insurance contracts, where indefinite payments are made but the value to be paid out is uncertain and unknown.

Depending on the level of uncertainty, scholars have classified Gharar as either Gharar Fāḥish (major uncertainty) or Gharar Yasīr (minor uncertainty). Gharar Fāḥish is not tolerated while Gharar Yasīr is tolerated.

Gharar Fāḥish is described as:

- Settlement risk, where the seller has no control over the future outcome (such as selling an item prior to obtaining possession of it).
- Incorrect, false or inadequate information provided at the time of sale.
- Gambling.

c) Ḥarām (impermissible) activities

Islamic financial institutions and Muslims cannot finance/invest in activities or items forbidden in Islam, such as trade in alcoholic beverages, pork meat or prostitution. Shari’ah compliant investing prohibits financing of the production, packaging, marketing, and distribution of Ḥarām activities and products.

According to the Shari’ah, the following business activities are deemed impermissible:

- Conventional financial institutions, such as conventional banks and insurance companies.
- Production, packaging, bottling, storing, marketing, selling and distribution of alcoholic beverages and alcoholic associated products.
- Gaming/gambling/games of chance. Surah Māidah (Chapter 5, Verse 90) prohibits gambling.
- Production, packaging, storing, marketing, selling and distribution of pork and pork related products. Surah Baqarah (Chapter 2, Verse 173) prohibits pork.
- Production, packaging, storing, marketing, selling and distribution of non-ḥalāl food products. For example meat that is not slaughtered according to Islamic rites.
- Production, packaging, storing, marketing, selling and distribution of entertainment and leisure products related to pornography, music or with adult content.
- Arms, defense and military equipment manufacturers (may be permissible with conditions).
- Tobacco related products (not universal).
- Other categories deemed to be impermissible includes but is not limited to:
  - Prostitution, unisex massage parlours, escort and associated entertainment services, as well as companies whose activities or images are deemed to be offensive or contrary to the principles of Islam.
  - The advertising of unlawful products or services.
  - Human cloning*.

d) Profit and loss sharing

Shari’ah does not permit, nor advocate, the conventional principle of money earning money. Money is only considered as a medium of exchange. Islamic jurists consider money to be potential capital, rather than true capital. In essence, money must be placed in a permissible business venture in order to realise a permissible profit. Money, on its own, only yields interest. Therefore, Shari’ah promotes real business ventures that require capital or management, or both, from the parties involved. Furthermore, real businesses tend to benefit the community and the economy at large.

Money injected into a permissible business venture may be invested by one or more parties. The business venture entered into will either be successful thereby earning a profit, from which all parties will share, based on a pre-agreed profit sharing ratio, or it will suffer a loss, which is borne by the capital provider. Hence, if capital was invested by only one party and the other party invested skills, know-how, and entrepreneurship, the financial loss is borne by the capital contributor whilst the entrepreneur incurs losses in time and effort.

The basis of the profit and loss sharing rule is the famous tradition of the Prophet (PBUH) wherein he mentioned: “Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment.” (Muṣannaf ‘ibn Abi Sahybah).

This narration confirms that the profit sharing ratio should be agreed upon by the parties involved when entering into the contract, and losses will be proportionate to the investment made by each of the parties.

When agreeing on the profit share, a fixed amount, or a percentage of capital invested cannot be specified as one party’s share of profit. Rather, it will be necessary to mention a fraction or a percentage of the actual profit realised. Specifying a fixed amount of profit or a percentage of capital invested as one party’s share of profit is not in compliance with the above-mentioned tradition of the Holy Prophet (PBUH).

e) Asset backing

In Shari’ah, money has no real or intrinsic value and is only a measure of value, therefore one cannot be charged for its use. One of the most important characteristics of Islamic finance is that transactions are asset-backed, as opposed to currency backed. Profit is generated when an item having intrinsic value is sold or is leased for money, or when different currencies are exchanged. Any profit earned from the exchange of the same currency, is Ribā, and is prohibited. Unlike conventional finance where an asset is only utilised for collateral security purposes, Islamic finance requires that all transactions be backed by real tangible assets and inventories, thereby eliminating the occurrence of Ribā.
Financial institutions offering Shari’ah compliant financial services must establish Shari’ah Supervisory Boards (SSB) to oversee their practices and activities prior to the commencement of any business activities. The SSB comprises Muslim jurists and are tasked to act as independent Shari’ah auditors and advisors, vetting contracts, auditing processes, approving new product developments, and responsible for the calculation and distribution of non-permissible income. Members of the SSB enter into an agreement with the respective financial institution. In some countries the SSB is referred to as the Shari’ah Advisory Council.

**What is a Shari’ah Supervisory Board?**

A SSB is an independent body of jurists with specialisation in Fiqh ‘al-Muʿāmalāt (Islamic commercial jurisprudence). The main responsibilities of the SSB are directing, reviewing and supervising the activities of the institution to ensure compliance to Shari’ah. The Fatwas and rulings of the SSB are binding on the financial institution. The financial institution may allow its clients access to the rulings of the SSB. The Accounting and Auditing Organisation for Islamic Financial Institutions standards advise that a SSB must comprise at least three members. The current norm is between three and six jurists per SSB.

**What are the duties of the Shari’ah Supervisory Board?**

The duties include:

- Be independent and avoid all conflicts of interest;
- Review and approve the legal and operational structure of Shari’ah compliant products;
- Directing, reviewing, and supervising the Shari’ah activities of the institution;
- Issue compliance certificates for Shari’ah compliant products;
- Perform a periodic audit or review of Shari’ah compliant products;
- Attend SSB board meetings;
- Approve profit and loss allocations;
- Approve non-permissible income calculations and its purification process;
- Supervise and audit transactional procedures;
- Supervise the development of Shari’ah compliant products;
- Issue SSB reports confirming the SSB’s reviews;
- Supervise staff training in Islamic Finance.

**How is the Shari’ah Supervisory Board remunerated?**

Similar to a conventional auditing firm, the financial institution enters into a contractual relationship with members of the SSB that include the terms and conditions of their remuneration and responsibilities.
الزمن لا يغير، الزمن يكشف

Time doesn’t change, time reveals.
The notion of a contract in Islam is to facilitate the rightful and legitimate needs of people towards each other. A contract is known as ‘ʿAqd’ in Arabic, (meaning ‘to tie’) as it binds the offeror and the offeree. Contracts contain the purpose, rights and obligations of the parties and can include a broad range of relationships including religious, political, social or economic. Islamic commercial law requires the consent of both parties for a valid and binding contract to come into existence.

The traditions of the Holy Prophet (PBUH) reiterate the meaning and function of a contract and also illustrate what is defined as a valid and invalid contract. The Prophet (PBUH) said, “The property of a Muslim is not lawful for others to enjoy unless by the owner’s consent.” (Ahmed, al-Dārquṭni, al-Baihaqī).

The technical definition of a contract in Shari’ah is “the commitment of two parties and their undertaking of a matter as a result of combining the offer with the acceptance.” (‘Al Majallah).

Classification of contracts

A contract is classified according to the underlying transaction that aims to meet the needs of the parties involved. Once the nature of the transaction is identified, an appropriate contract is selected to regulate the transaction.

The general requirements for a valid contract in Shari’ah are the inclusion of the following:

- Offer
- Acceptance
- Offeror
- Offeree
- Object (merchandise)
- Consideration

Contracts can be classified as a contract of exchange or a contract of benevolence:

1. A contract of exchange is a contract between two parties to achieve some form of commercial gain. Any element of uncertainty, to the extent that it may lead to a possible dispute between the contracting parties, is avoided. Contracts of exchange are utilised by Islamic financial institutions to govern the nature of financial transactions and products. They can broadly be classified according to the following categories:
   - Sale contracts, of which the most common type used is Murābahah.
   - Transfer of usufruct/lease contracts, which are called Ijārah.
   - Contracts to do work, which are Wakālah/ Ijārah and Ju’alah contracts.

2. A contract of benevolence is a ‘one person’ contract where a person wishes to grant a favour to another with no return. Contracts of benevolence are gratuitous in nature and as they do not involve consideration, uncertainty is tolerated.
Islamic financial institutions are commercial enterprises whose business is the facilitation of financial services. Like any conventional financial institution, their clients include individuals, corporations, retirement funds, governments, state owned enterprises and the like.

Services include but are not limited to:
• Deposits
• Financing
• Sale and lease of assets
• Investment products
• Insurance products
• Estate planning, wills, trusts, etc.

The implementation of these financial activities are achieved through either:

• **Equity based financing:** a form of joint undertaking arrangement between the financial institution and the customer, where capital is provided based on a contracted and upfront agreed profit sharing ratio; or

• **Asset based financing:** where the institution finances the credit purchase or lease of an asset.

**Equity based financing**

This is a joint business venture between the Islamic financial institution and the customer. The customer and the institution act as partners in the venture. Equity based financing requires an agreed upon profit share between the financial institution and the customer. To mitigate risk, the parties may agree that profits will only be distributed once capital has been recovered.

There are two forms of equity based financing:

**a) Muḍārabah**

Muḍārabah is a financing arrangement where one party provides the capital and the other the business management skills, with profits shared according to a pre-agreed ratio between the parties. Monetary losses are borne solely by the capital provider. Management incurs losses based on the contribution of time and effort. Islamic financial institutions as provider of capital do not actively participate in the running of the business but do require timeous reporting on business activities and financial accounts as a means to monitor their risk exposure.

**b) Mushārakah**

Mushārakah is regarded as the most flexible contract. It is a financial arrangement based on Shirkah al ‘Amwāl, or partnership by capital. Risk exposure of the partners is proportionate to each partner’s ratio of capital contribution. It is a profit and loss sharing contract where all partners contribute towards capital and profits are shared according to an agreed ratio and losses are borne according to the ratio of capital contribution.

The capital can remain constant throughout the partnership or could also be redeemed prior to the end of the project period by the Islamic financial institution, where the Islamic financial institution sells portions of its share of capital to the client and over a period of time the client owns the entire asset or project. This is called diminishing Mushārakah or Mushārakah Mutanāqiṣah. Basically, the outstanding financing amount (capital) could increase or decrease, so the loss sharing ratio can be determined at any time.
Mushārakah also allows the financial institution to actively participate in the operational management of the business. This makes it a suitable financing mechanism for project finance transactions. If the financier wants to withdraw, the other party can purchase his share. This contract would include an exit clause with an agreed appraisal formula. Mushārakah financing can also be adapted to facilitate trade, asset, and property financing.

**Asset based financing**

Asset based financing is the financing of a credit purchase or lease of an asset. The financier acquires the asset and then either sells or leases it to the customer.

There are two common forms of asset based financing:

a) **Murābaḥah**

This is a popular form of financing for long and short-term asset financing. It is the sale of goods at cost plus profit. The financial institution meets the demand for goods by its customer through the purchase of the goods from a third party and sells the goods to its customer for a profit. The cost and the profit are disclosed and the financial institution bears the risk of the goods until delivery to its customer. The customer may order the goods, on behalf of the financial institution from the supplier. The payment period and amount to be paid is fixed between the financial institution and the customer.

b) **Ijārah**

Ijārah financing is a financing arrangement where the financial institution acquires an asset and leases it to a customer. This can either be an operating lease, Ijārah, or a lease with an option to transfer the asset to the lessee called Ijārah Muntahiyah bi Tamleek. Ijārah is essentially the transfer of rights of use or usufruct to another in exchange for rent. Ijārah does not cause ownership to be transferred to the lessee. The lessee has no claim to ownership over the asset unless the lessor sells it to him. Equipment, machines etc. may be financed through Ijārah.

**Other forms of financing**

Other forms of financing also exist, such as, Tawarruq, which is a commonly used contract to obtain cash or liquidity. This type of contract involves the purchase of a commodity by a financial institution from a third party and its resale to the client on a cost plus profit basis. The client then sells the asset in the market to obtain cash. It is a tripartite contract which facilitates cash financing.
The range of Shari’ah compliant banking and investment products is growing rapidly. Whilst countries in the Middle East and Malaysia dominate the development of the Islamic capital markets and the banking industry, western institutions have increasingly added Islamic banking and investment products to their offering to meet the growing demand, leading the way to increased competition, better products through innovation and overall cost reductions.

The modern Islamic financial services industry can be traced to the 1960’s. Below are some of the key milestones:

1963: The world’s first modern Islamic banking experiment began in Egypt. Services offered included savings and investment accounts.

1975: The Islamic Development Bank is established to provide necessary funding and support structures in order to promote economic development and social progress within members of the Organisation of Islamic Cooperation.

1975: The first Islamic private commercial bank, the Dubai Islamic Bank is established. Basic products were introduced in an attempt to replicate conventional banking products. The next decade witnessed a rapid growth in the number of Islamic banking service providers within the region.

1980: The International Islamic Bank of Investment and Development, Luxembourg is formed.

1983: Bank Islam Berhad is founded in Malaysia offering the first tools to screen shares for Shari’ah compliance facilitating the participation of Muslim investors in listed equities.

1986: The Amāna Income Fund is founded in Washington. It is managed by a non-Muslim named Nicholas Kaiser. It is the second largest Islamic mutual fund in the world with the largest being the Amana Growth Fund also managed by Nicholas Kaiser.

1990: Shell MDS Malaysia issues the first private sector Ṣukūk in Malaysia.

1999: The Dow Jones Islamic Market benchmark index is launched by Dow Jones & Company. The index is intended to provide a comprehensive representation of the global Shari’ah investable universe.

1999: The FTSE group launches the Global Islamic Index Series.

1999: The Kuala Lumpur Shari’ah Index is launched.

2001: The first corporate Ṣukūk is issued by Kumpulan Guthrie in Malaysia.

2002: The first Sovereign Ṣukūk is issued by the Government of Malaysia.

2006: The Dow Jones Citigroup® Ṣukūk Index (the “Ṣukūk Index”) is launched.

The Prophet (PBUH) was asked, “Which is the best of earnings?” He replied, “A person earning by his own hand and every (permissible) blessed trade.” (‘Al-Hākim)
2006: The world’s first exchangeable Ṣukūk is issued by Kazanah Nasional.

2007: The FTSE/JSE Shari’ah All Share Index is launched.

2011: The Central Bank of Nigeria (CBN) adopts the Malaysian banking model with the aim of a dual banking system. The CBN issues two licenses for Islamic banking operations.

2011: South Africa’s National Treasury invites banks to submit proposals for the issue of its first ever Ṣukūk.

2012: Abu Dhabi Islamic Bank launches the world’s first ever perpetual Sukuk.

2014: The UK becomes the first country outside the Islamic World to issue a sovereign Sukuk.

2014: South Africa launches its maiden sovereign Sukuk for $500 million.

2015: Ideal Ratings launches the first ever Shari’ah compliant REITS Index.

2015: Saudi Arabia’s $560 billion Tadawul stock exchange officially opens to foreign investors.

2016: First US Shari’ah compliant fixed income fund surpasses the $100 million assets under management mark.
The Shari’ah Alternative to Conventional Money Market and Fixed Income Products

Shari’ah compliant money market products

Conventional money market products invest in short-term debt securities, such as treasury bills and commercial paper. As these conventional money market products operate on the basis of Ribā, they are considered prohibited in Shari’ah. As mentioned earlier, Ribā is totally and completely prohibited in Shari’ah, therefore any product containing Ribā, or an element thereof, will also be prohibited.

The Shari’ah equivalent to conventional money market products is based on the requirement for products to be aligned with Islamic principles through the use of Shari’ah compliant structures (contracts). For example, the following contract types are utilised by financial institutions for the facilitation of Islamic money market activities:

- **Muḍarabah Interbank Investments** – banks borrow funds on the basis of Mudarabah (profit and loss sharing principles).
- **Murābahah** – this is a popular type of contract where an Islamic bank purchases an asset on a deferred payment basis and sells the asset in the market for cash.
- **Wakālah investments** – an Islamic bank accepts funding as an agent, where it invests on behalf of the investor and receives a fee. The Islamic bank may also be entitled to access gains earned over and above specified profits as an incentive.

Shari’ah compliant bonds: Şukūk

In conventional finance, a bond is a debt security, where the issuer has to make interest (Ribā) payments and pay the face value at a certain date to the holder of the bond. Also, the terms of the securities do not always correspond to the terms of the underlying project/s. Holders do not incur damages or losses of the issuer. The rights of the securities holders are not connected to the assets of the issuer and the prospectus issued does not include Shari’ah constraints. Conventional bonds are therefore not allowed in Shari’ah. Its Islamic equivalent is referred to as Şukūk or Islamic bonds. Şukūk are asset based investments where the investor owns an undivided interest in the underlying asset or project in proportion to his investment. The issuance of a Şukūk (plural for Sakk) certificate evidences ownership. Money raised by the certificates is used to invest in an asset or project. Each Şakk (certificate) issued represents ownership in the underlying asset or project. Holders of the Şukūk have a right to profits and also bear losses. The maturity of the Şukūk relates and corresponds to an underlying project or activity. A prospectus is issued, which includes all the Shari’ah rules relating to the issuer, manager and the Shari’ah rules that govern the Şukūk.

The growth of the Şukūk market is evident by the number of corporate and sovereign issues over the last decade. The dominant issues have mainly arisen out of the Middle East (Saudi Arabia, UAE and Kuwait) and in Asia (Malaysia and Indonesia). Many African countries such as Nigeria, Egypt and Tunisia are considering Şukūk issuances.

Currently, Şukūk is mainly accessible through the secondary market.
Key features of Ṣukūk

Ṣukūk is the process of aggregating tangible assets, usufruct, or projects into pieces that reflect proportionate ownership. Ṣukūk holders each have an undivided, beneficial ownership in the underlying assets or projects and are entitled to share in the revenues generated by the relevant assets or projects. Ṣukūk are neither debt certificates nor IOU’s. Returns are not fixed but are subject to the performance of the underlying assets or projects.

Ṣukūk are normally constructed in the following manner:

• The issuer will meet with an investment bank to coordinate the composition of the investment. The investment bank will revise the legal and operational documents, which will also be included in the prospectus.

• A Special Purpose Vehicle (SPV) is formed. The SPV is considered to be a separate legal entity that protects the investors in the case of bankruptcy so that creditors cannot claim more than what is contained in the SPV, nor can the bankruptcy of the issuing agent attach assets of the SPV. The SPV acquires assets on behalf of the investors or Ṣukūk holders.

• A third party will normally become the underwriter for the subscriptions and will give an assurance to buy all unsubscribed Ṣukūk.

There are four main types of Ṣukūk, namely:

a) Ṣukūk ‘al-ljārah: An asset is sold by the originator to the SPV that issues the Ṣukūk. The originator will then enter into a lease arrangement to lease the asset from the SPV. Ṣukūks, which are tradable, represent an undivided proportionate beneficial ownership in the leased asset. Ṣukūk ‘al-ljārah allows the rental payment to be fixed or floating, depending on the structure of the lease contract.

b) Ṣukūk ‘al-Murābaḥah works on a similar structure as Ṣukūk ‘al-ljārah, with the difference being that the asset is purchased from a third party and sold to the originator on a deferred payment basis.

c) Ṣukūk ‘al-Muḍārabah: A passive partnership is the basis of the Ṣukūk ‘al-Muḍārabah structure. In a Muḍārabah partnership, the capital is contributed by the Rabb al Māl (capital contributor) and managed by the Muḍārib (manager). Capital providers are the investors and the issuer will be the company and the manager.

Other characteristics of a Muḍārabah contract include:

• neither the profit nor the capital is guaranteed;

• the manager will not be responsible for the loss, unless it is caused by his negligence and misconduct;

• the profit sharing ratio can be revised with the consent of both parties.
d) Ṣukūk ‘al-Mushārakah: The basis of Ṣukūk ‘al-Mushārakah is also a partnership agreement, but it differs from a Muḍārabah partnership, as the capital is contributed by all partners. The profit in a Ṣukūk ‘al-Mushārakah is shared according to an agreed profit sharing ratio. Losses, however, are shared according to the ratio of capital contribution.

Ṣukūk may be viewed by many as a contemporary Islamic financial instrument. However, the term Ṣukūk, may be attributed to the first century AH (after Hijrah). A tradition in the Šaḥīḥ of Muslim refers to the term as Sikāk (translated as commercial paper). The underlying transaction that was evidenced by this commercial paper was invalid, hence the ruling of impermissibility by ‘Abū Hurairah (a companion of the Prophet PBUH).

The tradition is as follows:

‘Abū Hurairah said to Marwān (the Caliph of the time), ‘you have allowed the trade of interest?’ Marwān replied, ‘and how is that?’ ‘Abu Hurairah said, ‘you have allowed the sale of Sikāk and the Holy Prophet (PBUH) has indeed prohibited the sale of food before taking possession thereof.’ Marwān addressed the people and prohibited this transaction. A person named Sulaimān (narrator of this tradition) says, ‘I saw the guards confiscating this paper from people.’

A similar tradition is mentioned in the Muwaṭṭā of ‘Imām Mālik as follows: It has been reported that ‘Imām Mālik said that he heard of the introduction of Ṣukūk to people in the era of Marwān for the produce of the market at ‘al-Jār. People bought and sold the Ṣukūk amongst themselves before taking delivery of the goods. Zaib ibn Thābit (a companion of the Prophet PBUH) and another companion went to Marwān and said ‘you have allowed the trade of interest O Marwān’. Marwān replied, ‘I seek the Almighty’s protection, how is that?’ They said, ‘These Ṣukūk that people trade amongst themselves before taking possession of the goods’. Marwān sent guards to follow these people and confiscate the Ṣukūk and return the Ṣukūk back to the original owners.

This tradition may be explained as follows: Soldiers during that period were given Sukūk (notes or coupons) that could be redeemed for crops. Some soldiers sold the coupon for cash before actually taking possession of the crop. These traditions speak about the introduction of Ṣukūk at an early stage of the Islamic era. The underlying structure is prohibited and not the Ṣukūk concept, as is clear from the tradition of ‘al-Muslim, where the reason for prohibition is mentioned as the Prophet (PBUH) had prohibited the sale of crop before taking delivery of the crop.
Practice in South Africa

In 2014, South Africa became the fourth country in Sub-Saharan Africa to tap global Şukûk markets in raising funding. It was also the largest sovereign Şukûk issuance out of Africa at the time of its launch and remains the largest Şukûk issued out of Sub-Saharan Africa. South Africa was also the third non-Muslim majority country to issue a Şukûk. The issuance was hailed as a great success being four times oversubscribed and possibly paving the way for further issuances in the future and perhaps laying the groundwork for other State Owned Entities or South African corporates coming to market in the future.

The properties of the South African sovereign Şukûk were as follows:

- **Type:** Ijârah
- **Issue size:** $500 million
- **Coupon rate:** 3.90%
- **Coupon payment Date:** 7 October
- **Order book:** R2.2 billion
- **Date of issue:** 17 September 2014
- **Duration:** 5 years 9 months
- **Exchanges listed on:** Luxembourg Stock Exchange
- **Method of trading:** Over the counter through large market making banks
The Prophet (PBUH) said: “Certainly sustenance searches for a servant as does his death search for him.” (‘Ibn Ḥibban, ‘al-Ṭabrāni)

Investment in the listed shares of a company represents a proportionate ownership by the holder of the security in the company. Investors share in the risks and profits of the company and, as shareholders, have voting rights in the company. Returns in equities are generated through capital growth and the receipt of dividends. Investors can access equity exposure either directly through the outright purchase of shares listed on the stock exchange or can invest in equity unit trusts or mutual funds managed by professional and skilled asset managers who are responsible for expert stock selection and portfolio construction.

Shari’ah compliant equity investing is unique in that the conventional stock universe is subjected to a set of rules, and screens the result of which is a smaller constrained universe of stocks that is deemed Shari’ah compliant. The application of rules and screens is to eliminate those companies whose core business is either Ḥarām or earns the majority of their income through interest-bearing loans or deposits.

Shari’ah compliant equity investment process

The investment process comprises three essential steps:

- **Step 1: Core business screening**
  - Muslims are not allowed to invest (or have a direct involvement) in companies whose core business is considered prohibited under Shari’ah principles. Core business refers to the main business activities undertaken by the company.
  - **Prohibited business activities may include, but is not limited to, the following:**
    - Conventional financial institutions based on Ribā or Gharar, e.g. conventional banks and insurance companies.
    - Production, packaging, bottling, storing, marketing, selling and distribution of alcoholic beverages and alcoholic associated products.
    - Gaming/gambling/games of chance. Sūrah Māidah (Chapter 5, Verse 90) prohibits gambling.
    - Production, packaging, storing, marketing, selling and distribution of pork and pork related products. Sūrah Baqarah (Chapter 2, Verse 173) prohibits pork.
    - Production, packaging, storing, marketing, selling and distribution of non-ḥalāl food products. For example, meat that is not slaughtered according to Islamic rites.
    - Production, packaging, storing, marketing, selling and distribution of entertainment and leisure products related to pornography, music or with adult content.
    - Arms, defense and military equipment manufacturers (may be permissible with conditions).
    - Tobacco related products (not universal).

- **Step 2: Financial ratio screening**

- **Step 3: Dividend purification**
• Other categories deemed to be impermissible includes, but is not limited to:
  • Prostitution, unisex massage parlours, escort and associated entertainment services, as well as companies whose activities or images are deemed to be offensive or contrary to the principles of Islam.
  • The advertising of unlawful products or services.
  • Human cloning.

5% rule: If a company has a non-ḥalāl butchery or an alcohol section, and the income derived from it is negligible (less than 5% of total revenue), then scholars have allowed investment in such companies. However, the percentage of impure income earned by the investor as a result of these prohibited activities, referred to as non-permissible income, must be discharged to charity (see below section on dividend purification).

**Step 2: Financial ratio screening**

The financial statements of companies are put through a ratio test to determine their permissibility. The following ratios are applied:

• **Total interest-bearing debt should not exceed 30% of the company’s total assets.** This includes bank overdrafts, bonds, debentures, preference shares and the likes thereof.

• **Total interest-based assets should not exceed 30% of the company’s total assets.** This includes bonds, fixed deposits and other such interest earning instruments.

• **Net liquid assets (cash and receivables less payables) should not exceed 70% of the company’s total assets.** Note that some scholars prefer that the company’s net liquid assets should not equal nor exceed the market capitalisation of the company (see below). However, AAOIFI contends that this is not necessary.

**Scholars differ on the use of 33% or 30%:** This difference of opinion is based on the Ḥadīth: “A third and a third is much” (Ibn Mājah). Therefore some scholars prefer an exact third 33% and others 30% mentioning that a full third is too much. However, both views have worth and either could be adopted.

**Total assets versus market capitalisation:** Market capitalisation is the price per share multiplied by the amount of shares issued by a company. Total assets is the value of all the assets held by a company. Which is the most appropriate measure to value a company? Market capitalisation may be influenced by factors outside the company, such as market and investor perceptions. This may cause instability in the company’s share price, particularly in times of excessive market volatility. Hence, total assets may prudenty be considered a more stable reflection of the true worth of a company. An option may be to use fixed assets in companies that have asset bases and market capitalisation for companies that spend on research and development, as is the case with software development companies.

**Step 3: Dividend purification**

Non-permissible income refers to any income that a company receives that is not allowed in Shari’ah. For example, interest earned on bank accounts or income generated from prohibited business activities (income derived is less than 5% of total revenue). Embedded in the dividends paid to investors will be this impure income portion. Such impure income will need to be extrapolated from dividends received and discharged to charity. It is not permissible for Shari’ah investors to utilise or benefit from this non-permissible income.

The process of dividend purification or cleansing can be done at fund level (for mutual funds), or at investor level (where shares are held directly). Capital gains cannot be purified as it is not possible to attribute any gain in share price from such an insignificant contributor to income.
The Holy Prophet (May Peace Be Upon Him) cursed the one who consumes Ribā (interest/usury), the one who provides it, the scribe of a Ribā transaction and its witnesses, saying that they are the same.

("Al-Ṣaḥīḥ of Imām 'al-Muslim")
Setting Global Standards in Islamic Finance

The Prophet (PBUH) said: “Certainly Allāh loves the labouring, working believer.” (‘al-Bayhaqi)

Bodies responsible for setting international standards for the Islamic financial services industry include:

**Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)**

AAOIFI was established as a non-profit organisation in February 1990 in Algiers and was registered in Bahrain in 1991. AAOIFI develops accounting, auditing, governance, Shari’ah and ethical standards, relating to the activities of Islamic financial institutions. The standards issued by AAOIFI are compatible with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). AAOIFI has a Shari’ah board that discusses relevant Shari’ah matters and issues Shari’ah standards for the industry.

**Islamic Financial Services Board (IFSB)**

The IFSB based in Kuala Lumpur, Malaysia, was established in November 2002, and is responsible for setting standards for regulatory and supervisory agencies to help ensure the soundness and stability of the Islamic financial services industry.

**The Islamic Fiqh Academy (IFA) of India**

The IFA of India was founded in 1988 in New Delhi, India and is also an institution of collective interpretation. They operate in a similar manner to the IFA of Jeddah.

AAOIFI and the IFSB are the principal governing agencies that establish and promote informational guidelines for reporting and governance for the Islamic financial services industry. AAOIFI ensures that reporting information meets prudential standards and guidelines that encourage a sound and stable financial system.

The Fiqh academies focus on advance studies in Islam and often issue statements in terms of contemporary interpretations of the Qur’ān and Sunnah. These organisations conduct research and convene conferences to share findings and new developments in Islamic jurisprudence.

**The Islamic Fiqh Academy (IFA) of Jeddah**

The IFA of Jeddah was established in 1981 and is affiliated to the Organisation of the Islamic Conference and is based in Jeddah, Saudi Arabia. The IFA is considered an institution of collective interpretation and its members convene to debate on contemporary matters relating to Islamic law and issue relevant resolutions.
<table>
<thead>
<tr>
<th>Arabic Term</th>
<th>English Translation</th>
</tr>
</thead>
<tbody>
<tr>
<td>'Akhlāqiyyāt</td>
<td>Character, morals</td>
</tr>
<tr>
<td>'Allāh</td>
<td>God</td>
</tr>
<tr>
<td>'Aqāid</td>
<td>Beliefs</td>
</tr>
<tr>
<td>'Aqd</td>
<td>Contract</td>
</tr>
<tr>
<td>Bai`ud Dain</td>
<td>Selling a debt</td>
</tr>
<tr>
<td>Bai<code>ul Mu</code>ajjil</td>
<td>Delayed or deferred sale</td>
</tr>
<tr>
<td>Fāḥish</td>
<td>Major</td>
</tr>
<tr>
<td>Fiqh</td>
<td>Jurisprudence</td>
</tr>
<tr>
<td>Fiqh al Mu`āmalāt</td>
<td>Islamic commercial jurisprudence</td>
</tr>
<tr>
<td>Gharar</td>
<td>Deception or uncertainty</td>
</tr>
<tr>
<td>Ḥajj</td>
<td>Pilgrimage</td>
</tr>
<tr>
<td>Ḥanafī</td>
<td>Relating to Imām `Abū Ḥanīfah</td>
</tr>
<tr>
<td>Ḥanbalī</td>
<td>Relating to Imām Aḥmed ibn Ḥanbal</td>
</tr>
<tr>
<td>Ḥarām</td>
<td>Forbidden</td>
</tr>
<tr>
<td>Hiwālah</td>
<td>Transfer of debt</td>
</tr>
<tr>
<td>'Ibādat</td>
<td>Worship</td>
</tr>
<tr>
<td>'Ijārah</td>
<td>Leasing</td>
</tr>
<tr>
<td>'Ijmā’</td>
<td>Consensus</td>
</tr>
<tr>
<td>'Imām</td>
<td>Literally means leader and also used as an honorary title particularly for the founders of a school of thought in Islamic jurisprudence</td>
</tr>
<tr>
<td>'Injīl</td>
<td>Bible, divine book revealed to Jesus</td>
</tr>
<tr>
<td>'Iṣṭiṣnā‘</td>
<td>A sale where a product is requested to be manufactured or constructed</td>
</tr>
<tr>
<td>Jahālah</td>
<td>Unknown or uncertain</td>
</tr>
<tr>
<td>Kafālah</td>
<td>Guarantee</td>
</tr>
<tr>
<td>Mālikī</td>
<td>Relating to Imām Mālik</td>
</tr>
<tr>
<td>Mu`āmalāt</td>
<td>Dealings</td>
</tr>
<tr>
<td>Mu`āsharāt</td>
<td>Social activities</td>
</tr>
<tr>
<td>Muḍārabah</td>
<td>A special form of partnership involving an investment from one partner and management from the other</td>
</tr>
<tr>
<td>Muḍārib</td>
<td>The manager in a Muḍārabah</td>
</tr>
<tr>
<td>Murābaḥah</td>
<td>A sale wherein the cost and profit of the merchandise is disclosed</td>
</tr>
<tr>
<td>Musāwamah</td>
<td>A sale wherein the cost and profit of the merchandise is not disclosed</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>---------------</td>
<td>---------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Mushārakah</td>
<td>A joint venture where all the partners share in the profit and loss</td>
</tr>
<tr>
<td>Mutanāqiṣah</td>
<td>Diminishing partnership</td>
</tr>
<tr>
<td>Qiyās</td>
<td>Analogy</td>
</tr>
<tr>
<td>Qur’ān</td>
<td>Divine book of Islām</td>
</tr>
<tr>
<td>Rabbūl Māl</td>
<td>The investor in a Muḍārabah</td>
</tr>
<tr>
<td>Rahn</td>
<td>Pledge, mortgage</td>
</tr>
<tr>
<td>Ribā</td>
<td>Interest</td>
</tr>
<tr>
<td>Ribā al-Faḍl</td>
<td>The exchange of six usurious items</td>
</tr>
<tr>
<td>Ribā al-Nasī’ah</td>
<td>Interest on a loan</td>
</tr>
<tr>
<td>Riqābah</td>
<td>Supervisory</td>
</tr>
<tr>
<td>Salam</td>
<td>A sale where cash is paid for the future delivery of specific merchandise</td>
</tr>
<tr>
<td>Shāfi’ī</td>
<td>Relating to Imām Shāfi’ī</td>
</tr>
<tr>
<td>Sharīk</td>
<td>Partner</td>
</tr>
<tr>
<td>Ṣalah</td>
<td>Prayer</td>
</tr>
<tr>
<td>Ṣawm</td>
<td>Fasting</td>
</tr>
<tr>
<td>Shahādah</td>
<td>Testimony (in the oneness of Allāh)</td>
</tr>
<tr>
<td>Shari’ah</td>
<td>Islamic law</td>
</tr>
<tr>
<td>Shirkah</td>
<td>Partnership</td>
</tr>
<tr>
<td>Sunnah</td>
<td>Practices of the Holy Prophet (PBUH)</td>
</tr>
<tr>
<td>Ṣukūk</td>
<td>Plural of Ṣakk, Islamic bonds, deed, document</td>
</tr>
<tr>
<td>Surah</td>
<td>Chapter of the Qur’ān</td>
</tr>
<tr>
<td>Taurah</td>
<td>Torah, divine book revealed to Moses</td>
</tr>
<tr>
<td>Tawarruq</td>
<td>Buy spot and sell deferred payment or vice versa to facilitate cash liquidity</td>
</tr>
<tr>
<td>Yasir</td>
<td>Minor</td>
</tr>
<tr>
<td>Takāful</td>
<td>Islamic insurance</td>
</tr>
<tr>
<td>Wa’d</td>
<td>Oath, promise</td>
</tr>
<tr>
<td>Wadi’ah</td>
<td>Safe custody</td>
</tr>
<tr>
<td>Wakālah</td>
<td>Agency</td>
</tr>
<tr>
<td>Zabūr</td>
<td>Psalms, divine book revealed to David</td>
</tr>
<tr>
<td>Zakāh</td>
<td>Discharging 2.5% of specific wealth annually</td>
</tr>
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After all patience, beautiful things await.
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