Chapter 1

Easing into Islamic Finance

In This Chapter

- Examining the core ideas of the Islamic finance industry
- Getting to know industry products and institutions
- Recognizing current and potential demand for Islamic financial products

Islamic finance has become an especially hot topic since 2007, when the global financial crises started doing serious damage. Nearly everyone felt the pinch of these crises. Now, academics, businesspeople, politicians, and religious leaders — in Muslim and non-Muslim nations, in the East, Middle East, and West — are talking about the significance of the Islamic finance industry. In part, that's because the Islamic system has survived these crises with less stress and better performance than many nations' conventional industries. People are curious to find out why that's the case and how Islamic finance differs from its conventional counterpart.

In this chapter, I offer a broad overview of the Islamic finance industry to help you get a handle on the concepts behind it, the principles that define it, the products that support it, the people who participate in it, and more. I then touch on the industry's current level of demand and project how much (and how quickly) it's likely to grow — topics that receive much more attention later in the book.

Defining the Concepts and Principles of Islamic Finance

Islamic finance is a financial system that operates according to Islamic law (which is called *sharia*) and is, therefore, sharia-compliant. Just like conventional financial systems, Islamic finance features banks, capital markets, fund managers, investment firms, and insurance companies. However, these entities are governed both by Islamic law and the finance industry rules and regulations that apply to their conventional counterparts.

Although the Islamic finance industry itself is quite young, Islamic theories of economics have existed for more than a millennium; by the mid-12th century, in fact, many Muslims scholars had presented key concepts of Islamic economics that are still relevant today. But political and social turmoil put the brakes on Islamic finance for a very long time; only in the 20th century did Muslim scholars and academics seriously begin to revisit these topics (and, in doing so, set the stage for the modern Islamic finance industry to emerge in the 1970s). Chapter 3 offers some details about the history of the Islamic finance industry, starting in the 6th century and including the explosion of activity that occurred in the late 20th century.

In this section, I introduce the concepts that support the Islamic finance system and the principles that every institution within it must apply.

Searching for balance

As I explain in detail in Chapter 2, Islam is more than a religion; it's also a code of life that deals with social, economic, and political matters. A person who follows Islam is a Muslim, and every Muslim is expected to live according to the Islamic code, which is sharia (Islamic law). Each issue addressed by sharia is entwined with all other issues; therefore, economic matters are related to religion, culture, ethics, politics, and so on. (Contrast this perspective with the economics of Adam Smith or Karl Marx, for example, whose philosophies exist independent of religious principles, beliefs, and culture.)

Islamic economics is based on core concepts of balance, which help ensure that the motives and objectives driving the Islamic finance industry are beneficial to society. I explore these core concepts here.

Balancing material pursuits and spiritual needs

Islam encourages spirituality in all pursuits. That doesn't mean that Muslims are ordered to avoid economic activities or the pursuit of wealth. Instead, a Muslim's economic activities and pursuit of wealth should correlate with the spiritual aspects of life. For example, someone shouldn't focus on business success so much that he neglects worship.

REMEMBER

The sources of Islam (which I describe in Chapter 2) teach Muslims that economic activity conducted according to sharia is, itself, an act of worship. That is, Muslims will be granted rewards or merits for sharia-compliant economic activities just as they're rewarded for worshipping Allah (God). But the key to achieving such rewards is to find balance between economic activities and spirituality, as I explain in Chapter 5.

Balancing individual and social needs

Islamic economics is also framed on the balance between the individual's needs and those of other people. A Muslim is expected to consider society in general when enjoying the bounties granted to her by Allah. These considerations include promoting justice in all economic activities, remembering that all people have mutual responsibility for all others, and using the earth's resources wisely. I devote Chapter 5 to Islamic commercial ethics, which include these topics and more.

If you've studied conventional economics, you may be wondering how Islamic economics deals with supply and demand. From a conventional perspective (such as capitalist or socialist), the question is, "How does an economy satisfy unlimited wants with limited resources?" The way a given economy answers this question influences what is produced, how it's produced, and for whom it's produced.

REMEMBER

According to Islam, the economic problem at the heart of this debate can't arise because Islam doesn't accept that all human wants must be fulfilled. In other words, the religion establishes limits on demand based on guidance from Allah.

Islam promotes moderate consumption and prohibits extravagant spending. That word *extravagant* applies both to spending too much on acceptable products and activities and to spending any money at all on prohibited ones. For example, people are involved in extravagant spending when they use consumable resources (especially food and drink) in an irresponsible manner but also when they drink alcohol, gamble, hire a prostitute, purchase pornography, or promote the production of weapons of mass destruction — all prohibited activities according to Islamic law.

So even though the supply of resources in this world is limited, Muslims believe that Allah has provided everything that humans need (and in an appropriate quantity). Islam ensures that humans use resources wisely by placing limits on demand through the directive to be moderate in consumption. While nations with conventional economic theories struggle with how to handle the push and pull between supply and demand, Islamic nations find the solution within the religion itself.

Believing that Allah is the owner of all wealth

Capitalistic societies are based on a concept of private ownership of property: Individuals hold different kinds and levels of wealth, and the government intervenes only when public interest demands it. Socialist theory is based on collective ownership, wherein wealth belongs to the state or the public; no individual ownership exists, and individual efforts don't result in a greater or diminished accumulation of wealth.

A core concept of Islam is that Allah is the owner of all wealth in the world, and humans are merely its trustees. Therefore, humans need to manage wealth according to Allah's commands, which promote justice and prohibit certain activities. At the same time, Muslims have the right to enjoy whatever wealth they acquire and spend in sharia-compliant ways; they don't need to feel shame about being wealthy as long as their behavior aligns with Islam.

To promote justice related to the distribution of wealth, Islam imposes a property tax called *zakat* (which is one of the obligations of Muslims; see Chapter 2). Every Muslim who meets certain criteria regarding the accumulation of wealth must pay zakat, which is distributed to people in need. In other words, zakat is a mechanism that promotes a just distribution of wealth among people. Islam also encourages charitable activities in addition to zakat according to an individual's preferences.

So how can a Muslim acquire wealth in a sharia-compliant way? Answering that question is one purpose of this book; I devote a lot of this text to explaining the types of financial products that support sharia-compliant economic activities. Basically, a Muslim may either inherit wealth or acquire wealth through business activities or projects that are based on contracts that exist within Islamic commercial law. In Chapter 6, you can find an overview of Islamic commercial contracts that support sharia-compliant business activities.

Promoting a responsible free-market economy

As the previous sections suggest, Islam defines certain limits on economic activities. A Muslim believes that Islam doesn't *restrict* economic activity but instead *directs* it toward responsible activity that benefits other people, protects the earth, and honors Allah. In other words, Islam allows for a free-market economy where supply and demand are decided in the market — not dictated by a government. But at the same time, Islam directs the function of the market mechanism by imposing specific laws and ethics, which I describe in Chapter 5.

A key purpose for imposing these laws and ethics is to promote social justice; Islam and social justice are inseparable. Therefore, social justice is a key concept of the Islamic finance industry.

What does social justice mean? As I mention in the section "Believing that Allah is the owner of all wealth," Islam doesn't allow for a society in which a small number of people enjoy most of the wealth while many people have very little. Economically speaking, *social justice* is the distribution of wealth in a way that helps correct such an imbalance.

Islam tries to achieve social justice in the economy in many ways:

- **Promoting adherence to Islam:** As I explain in Chapter 2, a Muslim is expected to adhere to certain core beliefs and perform certain obligatory acts. By reminding Muslims of their obligations, Islam seeks to promote stronger relationships between each person and Allah, between people and the earth, and among individuals. Islam affirms that when humans believe in Allah and follow his commandments, they create harmony on earth by behaving responsibly. Striving for social justice is the key to this harmony.
- **Requiring zakat:** By taxing the property of people who acquire wealth and distributing that tax to people in need, Islam promotes the socially responsible distribution of wealth. Zakat management is part of the Islamic finance field, and zakat calculation is a separate (specialized) field of study. I discuss zakat in Chapter 2 and in Chapter 14, where I describe financial statements that are required from Islamic financial firms.
- **Defining the state's obligations:** Per Islam, the state (meaning a nation's or city's leaders or government) is also responsible for ensuring that social justice exists. Islamic scholars argue that the state should collect zakat and guide wealth distribution to make sure that everyone's basic needs are provided for. In addition, scholars generally agree that states should protect the real value of money by implementing sound fiscal policy.
- **Prohibiting usury (interest):** As I explain in the next section, Islam prohibits interest-based transactions. It does so for the sake of social justice. No individual or business entity should hoard money in order to earn interest; instead, people and businesses should use money (keep it in circulation) to support productive economic activities — those that create investment, trading, and jobs. The returns of successful economic activities are then distributed to the different parties involved; wealth is shared.
- **Encouraging shared risk:** Islam also promotes social justice by encouraging risk-sharing in economic transactions. When a risk is shared among two or more parties involved in an economic activity, the burden of the risk faced by each party is reduced.

  For example, in a type of Islamic contract called *musharaka,* two or more parties participate in a joint venture by each providing capital, expertise, and effort. All parties share the risk, as well as any profits, related to the project. (I write more about musharaka contracts in "Products based on equity participation [profit and loss sharing]" later in this chapter.)

  Compare this with an economic activity supported by an interest-based loan from a conventional bank to an entrepreneur. If the venture fails, only the entrepreneur suffers; he must still pay back the capital to the bank as well as interest. But the entrepreneur takes this risk because he alone benefits from the profits if the activity is successful. He owes the bank no more than the capital borrowed plus the agreed-upon interest.

Citing key principles that Islamic firms follow

Based on the core concepts of Islamic economics, Islamic finance institutions adhere to certain principles that distinguish them from conventional finance. Here, I discuss four major principles that every Islamic financial firm must follow. (***Note:*** If a company doesn't adhere to these principles, it can't call itself *Islamic.*)

Prohibiting interest (riba)

Interest is the hub of the conventional finance industry wheel, which is one of the main reasons that Muslim scholars in the 20th century began to think seriously about the need for an alternative financial system (see Chapter 3). Western economics defines interest as the excess premium paid by a borrower to a lender over a period of time based on the principal amount that was loaned. The Arabic word *riba* refers to interest in the Islamic finance industry. *Riba* means to increase, grow, or multiply into more than what is due.

Riba is prohibited in Islamic law because it creates injustice in society and, as I note earlier in the chapter, Islam and social justice are inseparable. In a riba-based transaction, the owner of the wealth gets return without making any effort. The person receiving the loan, on the other hand, assumes all the risk related to the success or failure of the underlying economic activity and bears the responsibility of returning to the lender both the capital and the riba no matter what the outcome of the economic activity. From the Islamic point of view, in a riba-based transaction, the lender uses the misfortune of the borrower in order to acquire wealth, which is unjust. For these reasons, such a transaction can't be sharia-compliant.

The prohibition against riba-based transactions means that Muslims should not take out loans from conventional banks, invest in interest-based products (such as conventional certificates of deposit, savings accounts, and bonds), or invest in funds that purchase the equity of firms that promote interest-based products (such as conventional banks). The birth of the Islamic finance industry in the second half of the 20th century provided modern Muslims with their first access to financial products that respect such prohibitions.

Muslim scholars divide riba into two types:

- **Riba al-nasiah:** This riba is based on money lending; the lender and borrower agree upfront on a fixed amount of money to be paid as a reward for the money lent.
- **Riba al-fadl:** This riba is the excess that arises during an exchange of homogenous commodities in unequal quantities or qualities. If you have low-quality gold, for example, and you want to purchase high-quality gold, you can't exchange the two and pay the other party cash to make up the difference in value.

Steering clear of uncertainty-based transactions (gharar)

The Arabic word *gharar* means uncertainty or to cheat or delude. Islam requires Muslims to avoid transactions based on gharar because these transactions are uncertain or ambiguous; not everyone involved knows what to expect and can make an informed decision. Gharar can exist in these situations:

- **When two parties enter a contract and one party lacks complete information:** For example, a party purposely withholds some information in order to wield greater control over the transaction.
- **When both parties lack control over the underlying transaction:** They enter the contract aware that they don't have complete information because of the nature of the transaction itself.

Here's an example of the first situation: Mrs. Jones wants to buy a house and Mrs. Smith wants to sell her a house. If Mrs. Smith doesn't disclose complete information about the house she's selling (such as the fact that it flooded a few years ago or that it has foundation damage), Mrs. Jones can't make a fully informed decision. If the two parties enter a contract without complete disclosure being made, the contract is based on gharar and therefore prohibited under sharia law.

Likewise, the first situation may exist if two parties enter a contract for the sale and purchase of an item that hasn't yet been constructed, such as a new home. Unless the buyer and seller set out all the specifics in the contract (including the date on which the product will be complete), gharar comes into play, and the buyer may not ultimately receive exactly what he expected.

The second situation in which gharar exists occurs when, for example, two parties enter a contract related to the sale of fish that haven't yet been caught. Both parties lack control over that transaction because outside forces (such as weather or overfishing) may prevent the delivery of all the fish expected per the contract.

REMEMBER

The underlying issue with transactions that involve gharar is injustice; when uncertainty exists, the transaction can easily become unjust to one or both parties.

Avoiding gambling (maysir or qimar)

Two Arabic words — *maysir* and *qimar* — refer to transactions that involve gambling:

- **Maysir:** The acquisition of wealth by chance (not by effort)
- **Qimar:** In modern gambling, any game of chance

Both types of transactions are prohibited because they're based on gharar (uncertainty); no one can know with certainty how a gamble will pay off. When you also consider the core concepts supporting Islamic finance (described earlier in the chapter), you can see that in a maysir transaction, no sharia-compliant economic activity exists to justify the acquisition of wealth, making a maysir transaction unjust. And in qimar, only one party can gain; the other will suffer a loss and, therefore, an injustice.

The Islamic prohibition against transactions that involve gambling prevents Muslims from purchasing conventional insurance products because conventional insurance is a gamble. When a policyholder pays premiums, she doesn't know whether she'll get that money back (and perhaps much more money) in the future as the result of a qualifying event or whether the insurer will forever keep that money because no such event occurs. If a policyholder makes small payments and then receives a large sum because a misfortune occurs, that's unjust. If she makes small payments but never receives anything in exchange for them (because no misfortune occurs), that's unjust, too.

Instead, Islamic insurance, called *takaful,* is based on a very different model of risk management that involves shared risk and mutual responsibility; I describe the takaful industry in Chapters 18 and 19.

Avoiding investment in prohibited industries

Islam prohibits industries that it considers harmful to society and a threat to social responsibility. Earlier in the chapter, I mention the prohibitions against alcohol, prostitution, and pornography as well as weapons of mass destruction. Other prohibited products include pork, tobacco, and illegal drugs. Islam also prohibits activities that are based on interest (riba), gambling, or cloning (a prohibition that, obviously, has emerged only recently). Sharia scholars constantly debate new issues that arise as technology changes.

By prohibiting certain industries, Islam also prohibits profiting from them in any way. Therefore, an Islamic financial institution can't finance a project or asset that is prohibited. Also, a Muslim investor cannot put money into a mutual fund or other equity product that funnels money to a company that participates in a prohibited industry. In Chapter 12, I describe how an Islamic investment company filters stocks to determine which are sharia-compliant (and can be included in an Islamic investment product) and which aren't (and must be excluded).

Identifying Types of Islamic Financial Products

Islamic financial products are based on Islamic economic core concepts and principles, which I outline earlier in the chapter. Islamic financial companies have developed many different products to meet customer needs and provide sharia-compliant alternatives to widely available conventional options. All Islamic financial products are based on Islamic contracts — a topic that I detail in Chapter 6.

In this section, I link descriptions of some common categories of Islamic financial products with economic concepts and principles. Keep in mind that, in practice, a product can be developed to serve many purposes — not only to satisfy social justice demands. However, no matter the motivation for creating a product (such as to meet market demand), every Islamic financial product must exist under the framework of sharia law.

Products based on equity participation (profit and loss sharing)

To establish social justice, Islam requires that both investors and entrepreneurs share involvement in economic activities that result in profit and loss. The conventional concept of one party moving or transferring risk to another party is eliminated in the Islamic system. Here are two broad categories of well-known, widely used equity products that support the sharing of profit and loss:

- **Mudaraba products:** These are the most common products in Islamic financial institutions. In a *mudaraba* contract, a financier provides capital to an entrepreneur who manages an economic activity such as property construction, a business, or a joint venture. When this economic activity returns a profit, both parties share the proceeds; when a loss occurs, only the financier bears the financial loss. (The entrepreneur loses his effort and time.) However, if the loss is due to the misconduct of the entrepreneur, then he must suffer the financial loss as well.
- **Musharaka products:** In a *musharaka* contract, both parties become involved in a joint venture project or property by investing capital and entrepreneurship. Both parties share any profit or bear any loss generated by the activity.

TIP

For more information about mudaraba and musharaka products, check out Chapter 6 on Islamic contracts, Chapter 10 on Islamic banking products, and Chapter 13 on *sukuk* (the Islamic alternative to bonds).

Ultimately, the goal of these products is to help society — to promote social justice — by transferring money from one party to another in a way that benefits everyone involved (and even the larger community in some cases). In contrast, comparable conventional products are interest-based bank loans in which a bank transfers all risk of loss to the entrepreneur. In the end, the conventional bank benefits from this transaction much more than the entrepreneur does.

Products based on investment financing (sale and lease contracts)

In Islamic economics, debt-based transactions (interest-based lending and borrowing) are prohibited. If you've grown up in a society where every home, car, and other major purchase is financed by debt, you may wonder how people and businesses can function without it. But doing so is, indeed, possible!

As part of the Islamic finance system, contract products are available to facilitate the sale or lease of a property (a home or car, for example). You may see these contracts referred to as *debt-based;* but in reality, debt isn't created. Instead, an economic activity occurs that involves buying and selling a productive property or asset. Therefore, these types of transactions are more accurately called *asset-based* transactions.

Islamic law is clear: only real assets can be transacted with Islamic sale and lease contracts, and such assets must be owned by the lessee or seller — not by a third party. These conditions make it impossible to sell debt in a capital market and create imaginary assets, which enable transactions of a speculative nature.

Investment financing contracts in the Islamic system promote social justice because the seller or lessee shares the risk of the property or other asset (as well as the risk of credit default by the customer) while also enjoying a return on the investment. In other words, the customer isn't accepting a disproportionate amount of risk in this setup.

For example, if an Islamic bank purchases a home and sells it on an installment basis to a buyer, the bank is the owner of the home until the final payment is made. The bank earns a fee from the buyer but may also be responsible for repairs on the home for the duration of its ownership period if stated in the agreement.

Products based on investment financing include the following:

- **Murabaha products:** An asset is sold to the customer at cost plus markup. The sale amount is agreed upon by both parties in advance, and the purchase may occur over time in deferred installments or via a one-time payment.
- **Ijara products:** These are leasing products; a financier buys an asset that a customer needs and leases the asset to the customer.
- **Salam products:** In a salam contract, payment is made in full, upfront, for an asset to be delivered on a specific date in the future.
- **Istisna products:** Similar to salam products, istisna contracts are used for project financing; the financier pays for the project to be delivered in the future, and when the product is done, it's delivered to the financier.

Istisna and salam products are different because istisna contracts always relate to manufacturing, while salam can be related to any type of asset. Also, in salam, the full price must be paid in full upfront, which isn't necessary in istisna contracts.

As with equity participation products (check out the earlier section "Products based on equity participation [profit and loss sharing]"), Islamic investment financing products promote social justice by ensuring that both parties in the transaction share risks and receive rewards. In contrast, when a conventional bank offers a debt product to a customer (a home mortgage or auto loan, for example), the bank has little risk; if the customer defaults, the bank keeps the entire asset plus any payments that have been made to date. The conventional bank also stands to reap additional rewards, such as interest on the full amount due.

You can find much more information about Islamic investment financing products in Chapter 10.

Products for social development

The Islamic finance industry has developed a product based purely on the goal of lifting up society in general: *Qard hasan* are interest-free loans given by Islamic financial institutions to people who need them. This loan is the only type of loan that Islamic banks offer. No interest or fee is assigned to the loan; banks require only the principal to be repaid. See Chapter 9 for the details on qard hasan loans.

Islamic funds

Islamic funds are investment products (such as mutual funds and unit trusts) that are based on equities that are screened, or filtered, to ensure sharia compliance. (I describe the various types of Islamic investment products available in the capital markets in Chapter 11.)

The word *screened* is key here. As I explain in Chapter 12, *screening* refers to the process of checking the sharia compliance of every entity included in an equity fund. The first step in the screening process is to filter out any company whose business involves industries or types of transactions that are prohibited by Islamic law; sharia doesn't allow for investment in economic activity that may harm society. A second step in the process involves looking closely at each company's financial ratios; a company must meet certain financial benchmarks to assure Islamic investors that it isn't engaged in prohibited speculative transactions (involving uncertainty or gambling), which are likely leveraged with debt.

An alternative to bonds: Sukuk

Sukuk are often referred to as "Islamic bonds," but they're very different from conventional bonds, which benefit one party more than another and, therefore, can't promote social justice.

As I explain in the earlier section "Products based on investment financing (sale and lease contracts)," the Islamic finance industry avoids the creation of debt by offering asset-based contracts as an alternative to conventional loan products. For this reason, sukuk are asset-based securities; they're certificates (sold to investors) that represent ownership in a tangible asset, service, project, business, or joint venture. Every asset that supports a sukuk must be sharia-compliant, meaning that if an asset is an economic activity such as a joint venture, that activity must be based on the types of Islamic contracts I describe in Chapter 6.

Check out Chapter 13 for a thorough look at sukuk, including when they were first issued, how they're structured, how investors profit from them, and what types of sukuk are available in the Islamic capital market.

Islamic insurance

Islamic insurance, called *takaful,* differs significantly from conventional insurance. As I explain in the earlier section "Not participating in gambling (maysir or qimar)," sharia-compliant Muslims can't purchase conventional insurance because it's based on transactions that are rife with uncertainty.

A wide variety of takaful products exist; they can insure a car, a business, a person's health, a family's education or retirement savings, and so on. Yet all are based on the concepts of cooperative risk sharing, mutual responsibility, mutual protection, and solidarity among takaful fund participants. In conventional insurance, risk is transferred from one party to another; but in Islamic insurance, risk is shared among the members in a collective manner. Head over to Chapters 18 and 19 to dive into takaful and *retakaful* (the Islamic reinsurance industry).

Introducing Islamic Financial Institutions

The Islamic finance industry is composed of many institutions that create and/or trade the types of products I outline in "Identifying Types of Islamic Financial Products." Although these institutions may have very different structures, types of customers, and goals, they all share one key element: To qualify as Islamic financial institutions, they must comply with Islamic law (sharia).

Here, I briefly describe the types of Islamic financial institutions that serve Muslim and non-Muslim populations throughout the world:

- **Islamic banks:** Banks are the backbone of the Islamic finance industry, and Islamic banks were the first type of institution to enter the industry in the late 1960s and early 1970s (see Chapter 3). As I detail in Part III of this book, Islamic banks have many functions that mirror those of their conventional counterparts, but they must fulfill those functions in sharia-compliant ways. Therefore, the products available at an Islamic bank look very different from those available at a conventional commercial bank. And the ways in which an Islamic bank invests its funds differ significantly as well.
- **Islamic capital market participants:** As I explain in Chapter 11, the Islamic capital market is where sharia-compliant financial assets are transacted. The individuals and institutions involved in the Islamic capital market work parallel to those in the conventional capital market, and they help investors find sharia-compliant investment opportunities. The Islamic capital market is open to any investors, including non-Muslim customers.

  Products that are bought and sold in the Islamic capital market include Islamic funds (see Chapters 11 and 12), sukuk (see Chapter 13), and Islamic interbank money market funds (which are quite new and just now developing). Therefore, capital market participants include Islamic investment fund managers, sukuk issuers (including governments and major corporations), high net worth individuals who need sharia-compliant products in which to invest their money, and any other individual or entity that seeks sharia-compliant and/or socially responsible investment vehicles. Because this capital market is very young, I expect that it will grow and include more types of investment products as the Islamic finance industry itself matures.
- **Islamic index providers:** When Islamic investment funds were first being developed, their investment performance was benchmarked against well-known conventional indexes (such as the S&P 500). But that comparison was flawed because Islamic funds can't invest in so many of the industries represented by those indexes. As a result, Islamic indexes emerged that now serve as more appropriate benchmarks for examining the performance of Islamic investment funds. Key index providers who offer Islamic indexes include Dow Jones Indexes, S&P, FTSE, and MSCI. I cover the importance of these indexes in Chapter 12.
- **Islamic insurance (takaful) providers:** As I detail in Chapter 18, takaful policyholders funnel funds into each takaful product to make it functional; stockholders supply the necessary upfront operating capital; and a takaful operator manages the whole process. This type of financial firm is very new, but it meets a huge need in the lives of Muslims who previously couldn't purchase insurance products because no sharia-compliant options existed.

Realizing Why Islamic Finance Is in Demand — and Growing

The growth of the modern Islamic finance industry is impressive because it proves that the industry is supplying products and services that are meeting a previously pent-up demand. Not surprisingly, the greatest demand for Islamic financial products comes from Muslim customers, who previously lacked sharia-compliant investment options, insurance products, and even bank accounts. And though current demand among Muslims is strong, the rapid projected growth of the Muslim population in the near future means that the Islamic finance industry is poised for significant expansion. (The current Muslim population worldwide is about 1.6 billion; by 2030, projections put it at about 2.2 billion.)

Existing demand for Islamic finance is mostly concentrated in the Middle East and Southeast Asia, where many high net worth Muslims have cash they want to invest and Muslim-run businesses seek sharia-compliant means of financing projects such as acquisitions and property construction. However, not everyone who seeks out Islamic financial products is Muslim.

REMEMBER

I see two primary reasons that non-Muslims are becoming increasingly interested in what the Islamic finance industry offers:

- **Social responsibility:** The level of social responsibility offered by Islamic products (which I explain earlier in this chapter) attracts investors who make decisions based heavily on moral and ethical guidelines.
- **Increased investment stability:** When the global financial crises began in late 2007, investors became acutely aware of the risks involved in trading debt-backed securities (such as mortgage securities). Because Islamic finance doesn't allow for selling debt (see the earlier section "Products based on investment financing [sale and lease contracts]"), its products were largely protected from the subprime mortgage crisis that threatened so many conventional portfolios.

  To be clear, the Islamic finance industry *has* been shaken by the global financial crises; it couldn't possibly be immune. But it has suffered comparatively small losses (see Chapter 4), which has piqued interest in the types of products it promotes. Even if someone doesn't have a vested interest in the types of industry screening done by Islamic investment funds, he may be attracted by the funds' stringent financial screening (which weeds out companies with overly risky financial ratios; see Chapter 12).

The Islamic finance industry is estimated to be worth $1 trillion at this point; in the past two decades, it's averaged (tremendous!) growth of 14 percent per year. Although the Islamic sector currently represents only 1 to 2 percent of the total global finance industry, that percentage seems certain to increase.

As Islamic financial professionals continue to develop innovative products that meet diverse customer needs while maintaining sharia compliance, I'm confident that the size and reach of the Islamic finance industry will expand significantly. As I outline in Chapter 20, Western nations have very good reasons to pay attention to what's happening in Islamic finance today because it will undoubtedly influence what happens in their own financial markets in the near future.