

## **Islamic finance services and their application to the Italian financial system**

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### **Abstract**

The Islamic financial system is taking on an increasingly significant role in the International scene and is becoming a model which could constitute a valid alternative to our traditional financial system. At the base of this alternative system is the *Sharia*, that body of religious, ethical and moral norms which make up the Islamic religion and which govern the life of its followers in all its aspects, from the most private and personal to the social sphere, including economic and commercial issues. These norms are embodied in various concrete precepts, the most characteristic of which is surely the prohibition of *riba*, that is, of interest: the creation of money from money is in fact forbidden as it is considered a kind of usury (hence the expression *riba*: “interest usury”). The Islamic services therefore assume very different connotations from those to which we are accustomed: the applicant for a loan and the bank find themselves mutually involved in the results of the investment in a type of profit and loss sharing which is comparable to the functioning of a limited liability company. From these assumptions derives a series of Islamic contracts which focus on these very prerogatives and which create what is essentially a partnership between debtor and bank.

The aim of this paper is to analyze the services offered by an Islamic financial institution and verify their compatibility with existing financial instruments provided by traditional banks in the Italian context.

### **1. Islamic contracts for the banking system**

Islamic finance is deeply influenced by the features of Islamic law and follows the Koran's indications in economic activities. While conventional banks may easily just collect deposits from families and enterprises by granting loans, Islamic banks are involved in the sale and purchase of goods, according to the trade rules set by the *Sharia*. The profits of the former are connected to the difference between the interest rates earned on loans and those paid on deposits, while in the latter, as a result of the ban on interest, it is expected that income from business operations is derived from a real management activity<sup>1</sup>. The operating model of Islamic banks differs from traditional business enterprises, as a bank customer normally requires the supply of credit while Islamic banks sell goods on credit precisely by creating the credit through typical Islamic contracts, modified “ad hoc”.

The need is therefore to identify a series of contracts which meet these requirements and the changing needs of financial innovation. The following paragraphs discuss the types of contracts that are used by Islamic banks and indicate the characteristics and possible

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<sup>1</sup>Hamaui R., Mauri M., *Economia e Finanza Islamica*, 2009.

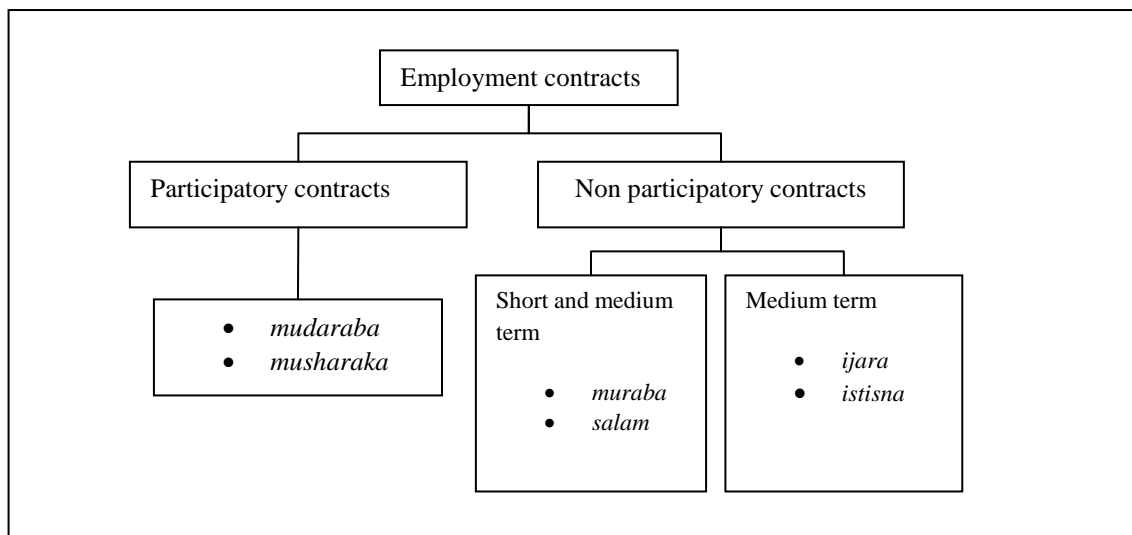
similarities with Western contracts in order to facilitate the understanding of their economic significance and method of accounting.

Several terminologies are used by Islamic banks to identify the services and products they offer which comply with the Sharia: some use Arabic terms, some a mix of Arabic and English, and others use the local language of the country in which the Islamic bank operates. Regardless of the terminology, Islamic bank contracts may be classified according to at least two perspectives:

- Contracts/instruments for collection and use;
- Participatory and not participatory contracts, depending on whether or not they are based on the Profit Loss Sharing (PLS) principle.

The diagram in figure 1 shows the main employment contracts, which are divided into participatory and non-participatory contracts. These are the most important types of Islamic contracts used by banks: *mudaraba*, *musharaka*, *muraba*, *salam*, *ijara*, *istisna*.

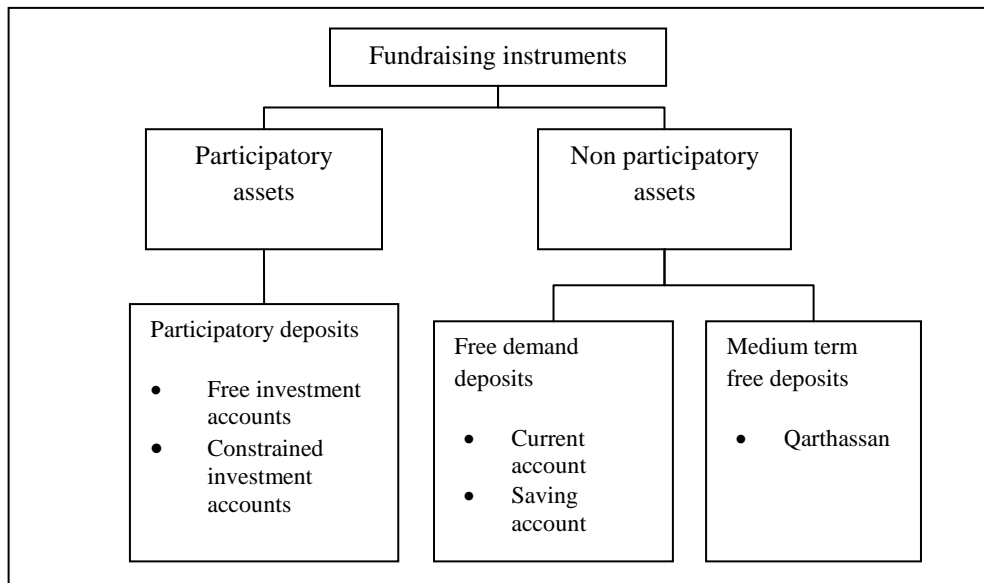
Fig. 1 Major contracts used by Islamic banks



Source: personal computing

Some of these contracts (such as Mudaraba, Musharaka, Salam, Ijara and Istisna) can be used in two different situations: between the bank and the customer using these funds, and between the bank and the customer using deposits, in the form of participatory deposits (unrestricted and restricted investment accounts).

Fig. 2 Major collection contracts/instruments of Islamic banks



Source: personal computing

The mechanisms and structure of the typical contract operations of Islamic banks will be investigated in the final part of the description, in order to examine the accounting problems and to identify their representation in the financial statements of banks, according to Islamic accounting principles.

## 2. Participatory Contracts: *mudaraba and musharaka*

The activities of Islamic banks, which are designed to meet the financial needs of Muslims who do not apply to traditional banks due to the presence of elements in their instruments that are not allowed by the Koran, such as interest and excessive risk, are now being extended to non Islamic customers as well. In order to remain competitive, Islamic banks should therefore provide similar, but highly effective services<sup>2</sup>. Since they have only existed for a short time, they are not, unlike traditional banks, experienced in providing articulated services which widely meet the customers' needs and increase customer loyalty. To attract customers, they should therefore offer more secure and profitable systems: participatory contracts (*mudaraba* and *musharaka*) have been identified as the best and easiest resource to help customers contain losses and enjoy the profits of transactions.

The *mudaraba* and *musharaka* contractual schemes are much used in the Islamic economic and financial system, securing agreements that involve profit and loss sharing; the main difference between the two lies in the investment management and the different modes of participation in the results.

*Mudaraba* is regarded as the essential tool of Islamic financing, aiming at the development of the economy. It is configured as a limited partnership, whose contributor (*rabb al-maal*) provides the capital, while the entrepreneur (*mudarib*) shares

<sup>2</sup>Haron S., Azim W., cit, 2009 pag. 288.

his work and management skills. Just like in Italian limited partnerships, the capital contribution by the limited partner, in the framework of the mudaraba, does not involve rights in shares of the company. The capital can be guaranteed by the entrepreneur who holds the funds and can make use of the contracts' limits, without being responsible for possible losses (unless he behaves in an incorrect manner). The divisional percentages of the profit must be defined a priori. In banking, as will be seen later, the lender and the bank will be fully responsible in case of loss.

The musharaka is a contract in which two or more members pool their capital and participate in the management of the company. In mudaraba contracts, as seen before, the lender merely supplies the funds and does not worry about the management. In musharaka contracts, on the other hand, the lender (usually the bank) acquires a part of the company's capital, becoming a co-owner and benefiting from the right to control the management, or at least to intervene. In the terminology of conventional finance, it can be compared to a joint venture. Any losses will be attributed to the parties in proportion to their capital, while profits will be distributed according to their percentages. These are established by the original contracts, and do not necessarily coincide with the percentages of ownership in capital<sup>3</sup>. Table 1 shows the differences between musharaka and mudaraba contracts.

The comparison shows that the mudaraba contract is by far the riskier instrument for banks, because the bank supplies capital to the customer, who embarks on an enterprise for which he is held responsible only in case of negligence and abuse. This creates an asymmetric risk, even if the bank takes precautions to contain its own risks. Table 2 highlights the operating mechanisms of both contracts and shows comparisons between their effectiveness and that of loans from conventional banks. In this last case, the risk of the transaction falls entirely on the customer, because regardless of its success, he will always have to match the predetermined interest.

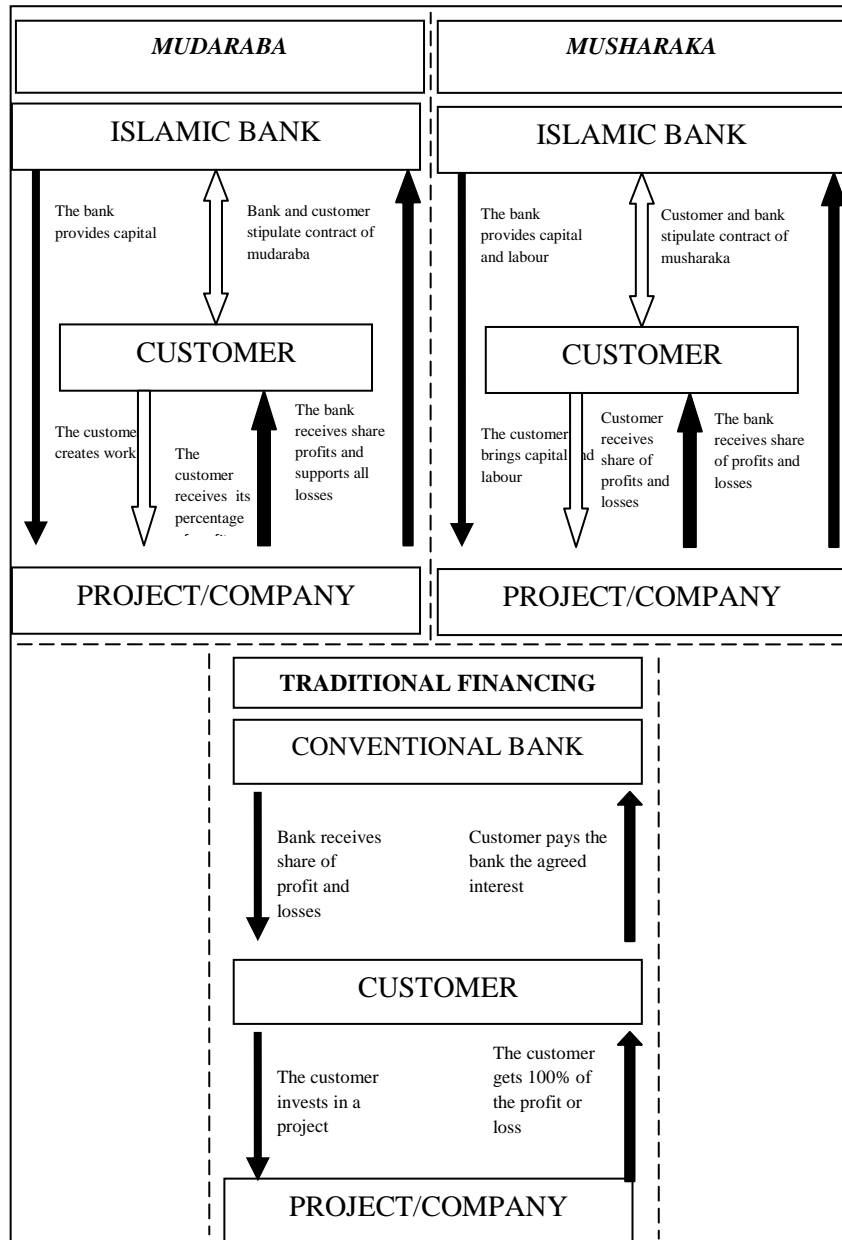
*Tab. 1 Comparison between musharaka and mudaraba contracts*

	MUSHARAKA	MUDARABA
Capital injection	All partners contribute capital.	The capital is only provided by the lender (Islamic bank).
Project management	All partners are involved in the management.	The bank has no right to participate in the management decisions, which are taken solely by the entrepreneur.
Profit distribution	Profits may be distributed at a fixed rate.	Profits may only be distributed at maturity, unless there are any advances.
Allocation of losses	Losses are distributed among all the partners in the agreed percentage.	The losses are borne by the supplier of capital (bank), unless there is gross negligence on the part of the user.
Type of reference company	Simple company (i.e., unlimited liability of partners) or Joint Venture.	Limited partnerships (limited liability to capital for the bank).
Ownership of assets	All partners are owners on the basis of their capital contribution to the project and benefit from any revaluation in the same manner.	Activities are property of the lender (bank).

*Source: personal computing taken from the tables of Atti A. and Miglietta F. (2009) and Usmani M. (2002)*

<sup>3</sup> AAOIFI, Accounting and Auditing Organization for Islamic Financial Institutions.

Fig. 3 Operating mechanisms of mudaraba and musharaka and comparison with the loans of conventional banks



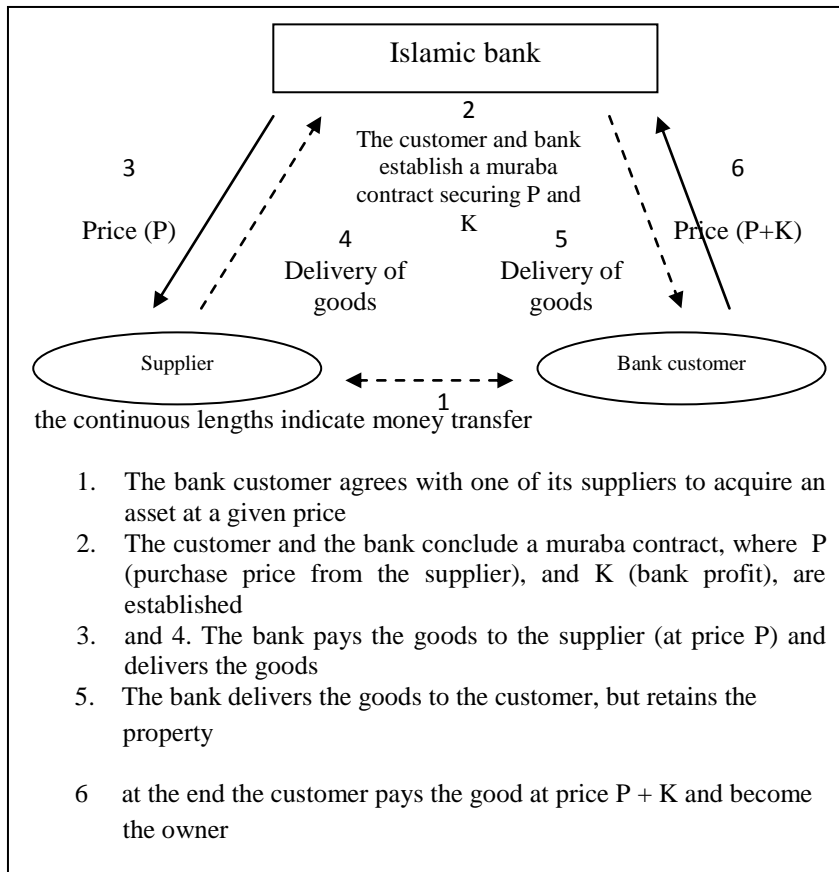
Source: personal computing

### 3. Non participatory contracts: muraba and salam are used to finance the circulating capital

In Islamic finance, as observed on several occasions before, classic forms of crediting, accompanied by the payment of interest, are not used: muraba and salam contracts are used instead. The former is the more frequent operation and is located in numerous circumstances, such as supplier credit, consumer credit, to finance assets (warehouse,

raw materials, semi-finished goods) and also for some investments in the medium and long term.

Fig. 4 Diagram of the muraba contract operation



Source: Adaption from Hamauri, Mauri, cit 2009.

From a legal point of view, it is a contract for the purchase of a good using the method of deferred payment; in the case of a banking transaction, the Islamic muraba provides for intervention by three parties: the customer of the bank, who is the final purchaser of the goods; the seller, who is the supplier of the goods and intermediary; and the bank, which is purchaser, supplier and seller for its customers.

There are two operations, one between the supplier of the goods and the bank, with an agreed price between the supplier and the customer, and the other between the bank and its customers, with a price equal to the cost, plus a margin that covers the service, the risk and the entity of the operation, of which the customer is informed prior to the conclusion of the contract (figure 4).

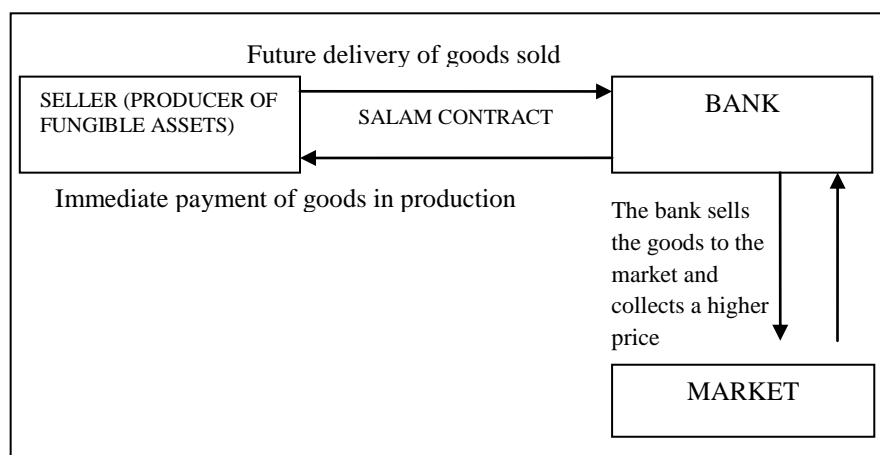
The salam contract is instead characterized by an immediate purchase/sale of goods and services with a separate regulation/delivery i.e. issue of immediate payment and deferred delivery.

It is less used than the muraba because it is considered an exception to the Sharia law (since it is based on a real asset that does not yet exist), and is allowed for small businesses and to facilitate exports.

This is a transaction on a good which does not yet exist, whose price is entirely embedded in the contract and has the function of a cash advance. The company that needs funds to finance working capital in a conventional bank would receive an advance against the payment of interest. This need of the company is satisfied, according to the perceptions of Islamic finance, precisely through the salam, by the sale of products to the bank, which will be delivered later, even if the price is established immediately under the penalty of invalidity.

In fact, instead of financing an existing product that will be delivered immediately, the salam allows you to disassociate the financed object, which will serve the goods' reimbursement: under these conditions, the immediate funding will be used for different commitments, related to the activity of the company, and will be reimbursed to a third party ( by a bank invoice) after the sale.

*Fig. 5 Diagram of a salam contract*



*Source: personal computing*

#### **4. Non participatory contracts: ijara and istisna are used to finance the fixed capital**

The ijaria contract is a type of leasing contract, very similar to the financial leasing, or operating, of both movable property and buildings.

The operation might be a simple lease, with a good that returns to the property when the contract expires, or may involve a purchasing option that can be exerted by the user.

In this case, Islamic banks buy the good and the rent from the provider for a given time, and the customer becomes a lessee and pays a fee (ij'rat) that covers the price of the

good with adequate remuneration. Just as in muraba, the bank acts in accordance with a customer's request and becomes the owner of the good, only to put it at its disposal.

The istisna is a contract widely used in the case of financing infrastructure or production plants, because it is a transaction related to a good that does not exist and that is ordered from the manufacturer on the basis of precise specifications. In these cases, the western companies use the sales contracts in the course of work. The majority of Muslim jurists consider the istisna to be a particular case of the salam. However, some consider it a contract of its own kind, detecting a lot of specificity: at the time of the contract's conclusion, the good may not yet exist and the price may not be adjusted immediately; the purchase relates to products intended to undergo transformations. On the contrary the salam, which relies only on the sale of goods, must have a price adjusted to it immediately (table 2).

*Tab. 2 Differences between istisna and salam*

	<i>istisna</i>	<i>salam</i>
Goods covered by the contract	The good is always something that needs to be made: it is a specific product and is not interchangeable with similar products.	The good can be anything that is needed or not, provided that it is a fungible good.
Price	The price does not necessarily have to be paid in advance. Not even the payment of the full price is required at the delivery date. Through agreement between the parties, payment may be carried out in various stages of work in progress.	The full price must be paid in advance.
Delivery date	It must not necessarily be fixed.	The date of delivery is an essential part of the contract.
Termination of the contract	The contract can terminate before the manufacturer starts the job.	The contract cannot be canceled unilaterally.

*Source: personal computing.*

With this agreement ends the list of the main banking contracts, which will also be considered in the accounting. Of course, there are also other types of contracts which are used sporadically and that are not assured by the law.

## **5. Spread in use of major contracts**

Islamic jurists generally urge banks to use participatory contracts (PLS), as they are closer to the principles of Islamic law, which are: equilibrium, stability and equality. In fact, some studies of the AAOIFI (2010) show how, on the contrary, the non PLS tools are by far the most used. Actually, even if the various instruments of financing businesses affect the banks' accounting to different extents, there is an average of 45-93% of muraba contracts used, making them by far the most used, and a much lower



percentage for all others (ijaria 0-14%, musharaka 1-20%, mudaraba 1-17%), while the salam almost disappears from the banks' balance sheets.

Sharon and Azmi (2009), who investigated the budgets of some Islamic banks in 2007, examining the percentage of use of the main financing contracts, reach similar conclusions.

Table 3 shows that although the principles of mudaraba and musharaka (profit and loss sharing) are recommended by Islamic jurists, there are still some banks that have not adopted them. Only the Bank of Indonesia is extremely consistent in following these religious dictates 100%.

*Tab. 3 Percentage of funding for separate types of contracts in some Islamic banks (2008).*

Contracts/Banks	<u>Malaysia</u> , Bank Islam Malaysia	<u>Bahrain</u> , Shamil Bank of Bahrain	<u>Bangladesh</u> , IslamiBank Bangladesh	<u>Indonesia</u> , BankMuamalat Indonesia
<i>Musharaka</i>	-	8,8	0,1	43,2
<i>Mudaraba</i>	0,09	9,7	*	56,8
<i>Muraba</i>	17,7	75,0	50,9	-
<i>Bai bithamalajil</i> **	52,8	-	-	-
<i>Ijara</i>	2,6	4,9	-	-
<i>Qardhassan</i>	-	-	1,3	-
<i>Istisna</i>	4,9	-	-	-
Other contracts	21,9	1,6	47,7	-
Total	100	100	100	100

Contracts/Banks	<u>Kuwait</u> , Kuwait Finance House	<u>Turkey</u> , AlbarakaTurk	<u>EAU</u> , Dubai IslamicBank	<u>Jordan</u> , Islamic International ArabBank
<i>Musharaka</i>	-	-	7,8	0,1
<i>Mudaraba</i>	-	-	11,3	3,8
<i>Muraba</i>	91,0	-	45,1	68,1
<i>Bai bithamalajil</i> **	-	-	-	-
<i>Ijara</i>	-	-	18,5	19,3
<i>Qardhassan</i>	-	-	-	0,2
<i>Istisna</i>	8,9	-	13,5	-
Other contracts	-	-	3,8	8,5
Total	100	-	100	100

\*less than 0,05%

\*\* type of sale with deferred payment, similar to muraba

Source: Haron S., AzmiW., 2009.

## **6. The development prospects of the Islamic bank in Italy**

There are different estimates of the number of Muslims in Italy in 2010 that indicate a presence of between 1,4% and 2.5% of the Italian population. However, it is generally agreed that the Muslim community is constantly expanding.

As far as the spread of Islamic finance is concerned, there are no Islamic banks in Italy or Islamic subsidiaries or branches, apart from some attempts by Italian banks such as Intesa Sanpaolo, Unicredit, Banca Sella and Banca Etica to open counters "dedicated" to facilitating the knowledge and use of traditional products and services.

In 2006 the Assaif - Association for the Development of Alternative Instruments and Financial Innovation was also established, with the aim of devising alternative financing services suited to the needs of the immigrant Muslim population, and compatible with Italian banking and tax regulations. Further research and initiatives are being carried out by the Italian Banking Association (ABI), but for now a service of Islamic finance does not exist and interested Muslims must apply to Islamic banks and counters in other European countries, particularly in the London market.

The legal and financial possibilities of opening an Islamic bank in Italy or at least Islamic counters in a traditional bank are being investigated. However, important problems emerge relating to coordination with the institutions foreseen in our banking arrangements, particularly with reference to the operations of PLS, the obligation of repayment of capital ratified in Article. 11 of the Banking Act, the recognition of the role of the Sharia Supervisory Board and its role in governance.

In addition to the difficulties of introducing the Islamic banking scheme into our system regulated by the Banking Act, the integration would find obstacles in tax laws such as the double taxation due to operations which are based on a twofold change of ownership and the non-tax deductibility of similar expense interests. In this regard, however, it must be noted that other legislations, for example in the United Kingdom, have had to face similar problems but have come to a satisfactory solution.

Additional issues may help make it difficult to integrate the Islamic system in the Italian context, such as the absence of an appropriate level of accounting harmonization and standardization of products and services.

Moreover, the Bank of Italy in a study in 2010 points out that the spread of Islamic finance in Italy is an important opportunity and a tool for attracting liquidity and capital from the Arab countries while at the same time facilitating the internationalization of local companies engaged in activities and investments in the countries bordering the Mediterranean, because they could support these with financial instruments appropriate to the realities they have to face.

These considerations indicate that the Italian system is closely monitoring the situation in order to achieve the establishment of appropriate Islamic systems.

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