***H.G. Rammal**, The University of Adelaide, Australia*

HISTORY OF ISLAMIC FINANCING

The guiding principle in Islamic Financing is the prohibition of *Riba* (interest) in the light of the *Shari'ah* ruling. *Shari'ah* refers to Islamic law, which is based on the teachings of the Quran. Since Muslims are not permitted to receive or pay interest, they are unable to conduct business with conventional banks (Ariff 1998; Jaffe 2002). To service this niche market, Islamic financial institutions have developed a range of interest-free financing instruments that conform to *Shari'ah* ruling, and therefore are acceptable to their clients (Malaysian Business 2001). While interest-free financing was practiced prior to the advent of Islam, the first successful application of Islamic finance in the modern era was undertaken in 1963 by Egypt's Mit Ghamr Savings Banks, which earned its income from profit-sharing investments rather than from interest (Lewis & Algaoud 2001). By the 1970's, the push for Islamic finance had gained momentum. In 1973 the conference of foreign ministers of Muslim countries decided to establish the Islamic Development Bank with the aim of fostering economic development and social progress of Muslim countries in accordance with the principles of *Shari'ah* (Saeed 1996). This marked the first major collective step taken by Muslim countries to promote Islamic finance (Rammal 2004). Since then Islamic financing has witnessed rapid success with holdings of more than US$147 billion and growing by 15 percent per year (Ghannadian & Goswami 2004).

The market leaders in this industry are Citigroup, HSBC, J.P. Morgan, and Standard Chartered who provide Islamic financing products through the use of Islamic windows (Day 2003). The main Islamic financial products include the profit-and-loss sharing instruments of *Mudaraba* (finance trusteeship) and *Musharaka* (equity partnership), cost plus mark-up, and leasing (Rammal 2003).

Although Islam excludes interest earnings from financial activities, it does not necessarily mean that the financier cannot earn a profit. In order to do so, the financier has to ensure that gains made on the original amount are directly related to the risk undertaken on the investment (Siddiqui 1987). If there is no risk involved, the gains made represent interest rather than profit.

In order to understand how the Islamic system differentiates between profit and interest, one has to look at the differences in the economic ideology. In a capitalist system, capital and entrepreneurs are treated as two separate factors of production. The return on capital is interest, whereas the entrepreneurs' return can be profits or losses. While interest is a fixed return for providing capital, profit can only be earned after distributing the fixed return to land, labour and capital (in the form of rent, wage and interest). Thus, the capitalist system seems to favor capital investors by providing them a secure return while the entrepreneurs bear the risks of incurring losses and still making interest payments on borrowed capital (Rammal & Zurbruegg 2004).

In comparison Islamic economic system does not consider capital and entrepreneur as separate factors of production. It believes that every person who

contributes capital in the form of money to a business venture assumes the risk of loss and therefore is entitled to a proportional share in the actual profit (Siddiqui 1994). The system is protective of the entrepreneur, who in a capitalist economy would have to make fixed interest repayments even when the venture is making a loss (Usmani, M.I. 2002). Capital has an intrinsic element of entrepreneurship, so far as the risk of the business is concerned and therefore, instead of a fixed return as interest, it derives profit. The more the profit of the business is, the higher the return on capital will be. With no fixed interest repayments, the profit in an Islamic economic system would be higher than in the capitalist economy. The system ensures that profits generated by the commercial activities in the society are distributed equally amongst those who have contributed capital to the enterprise.

Another difference between the two economic systems lies in the way money is used. In economic terms money has no intrinsic value; it is only a medium of exchange, therefore earning interest on a medium of exchange without bearing any risks does not sit well in the Islamic system (Rahman 1994). Islamic financing is therefore an asset-backed financing. When a financier contributes money on the basis of the profit-and-loss sharing instruments, it is bound to be converted into assets having intrinsic value (Usmani, M.T. 1998).

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