

UNDERSTANDING ISLAMIC BANKING AND FINANCE
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AT
SENSITIZATION WORKSHOP FOR JOURNALISTS ON THE
FUNDAMENTALS OF ISLAMIC ECONOMICS, BANKING
AND FINANCE

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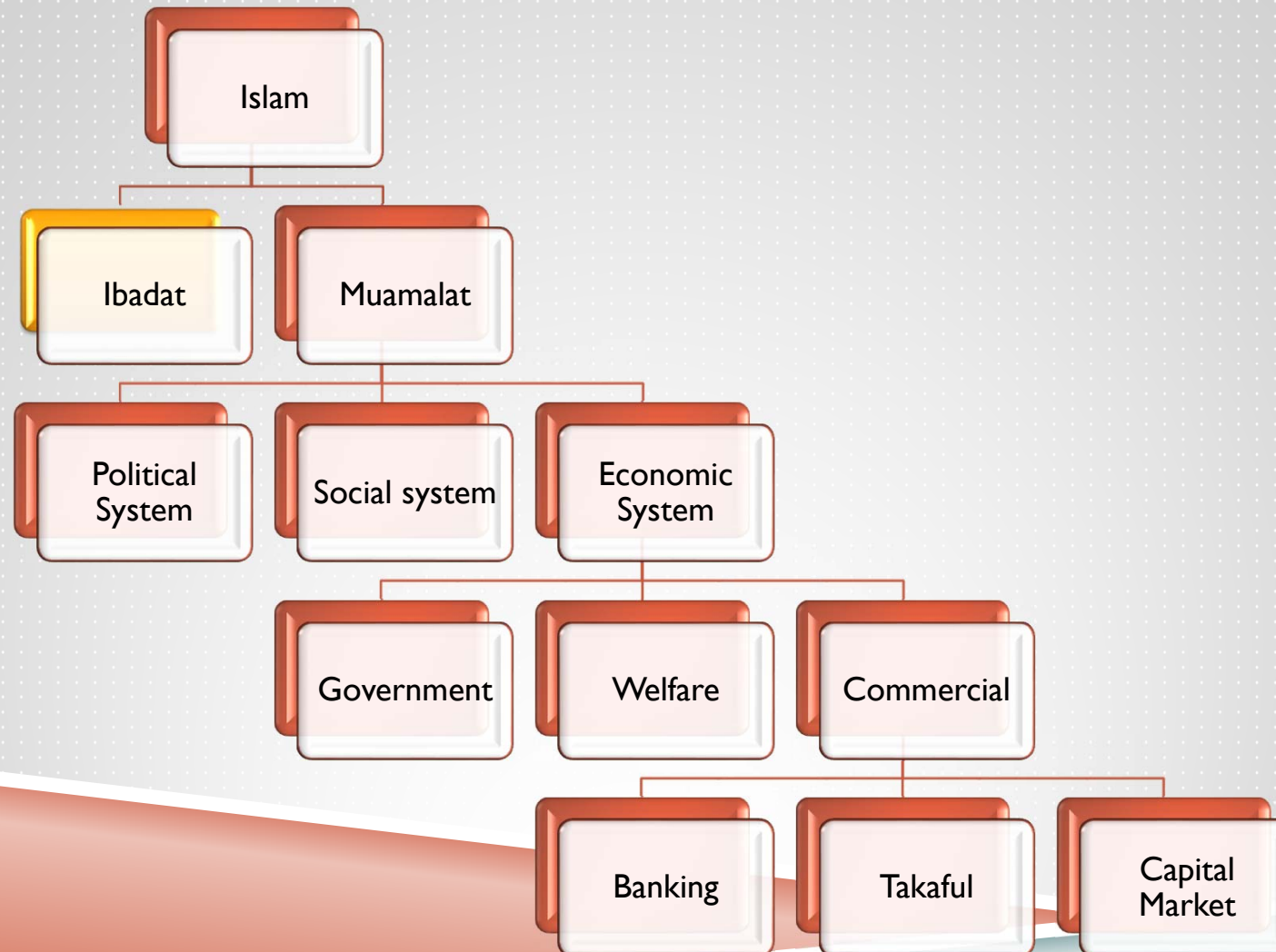
LEARNING OBJECTIVES

- ❑ Identify the position and importance of Islamic financial institutions in the Islamic economic system
- ❑ Understand the difference between Islamic and Conventional financing
- ❑ Understand the evils of compound interest
- ❑ Understand some modes of Islamic finance
- ❑ Identify, and understand some important features of Islamic banking, Takaful [Islamic insurance] and Islamic Capital market

WE BELIEVE: JUDAISM, CHRISTIANITY AND ISLAM

- ❖ Connection between Humankind's This-Worldly action and the Hereafter
- ❖ Wealth belongs to God
- ❖ Responsibility of the rich to help the poor and the needy
- ❖ Income and wealth distribution
- ❖ Prohibition of interest

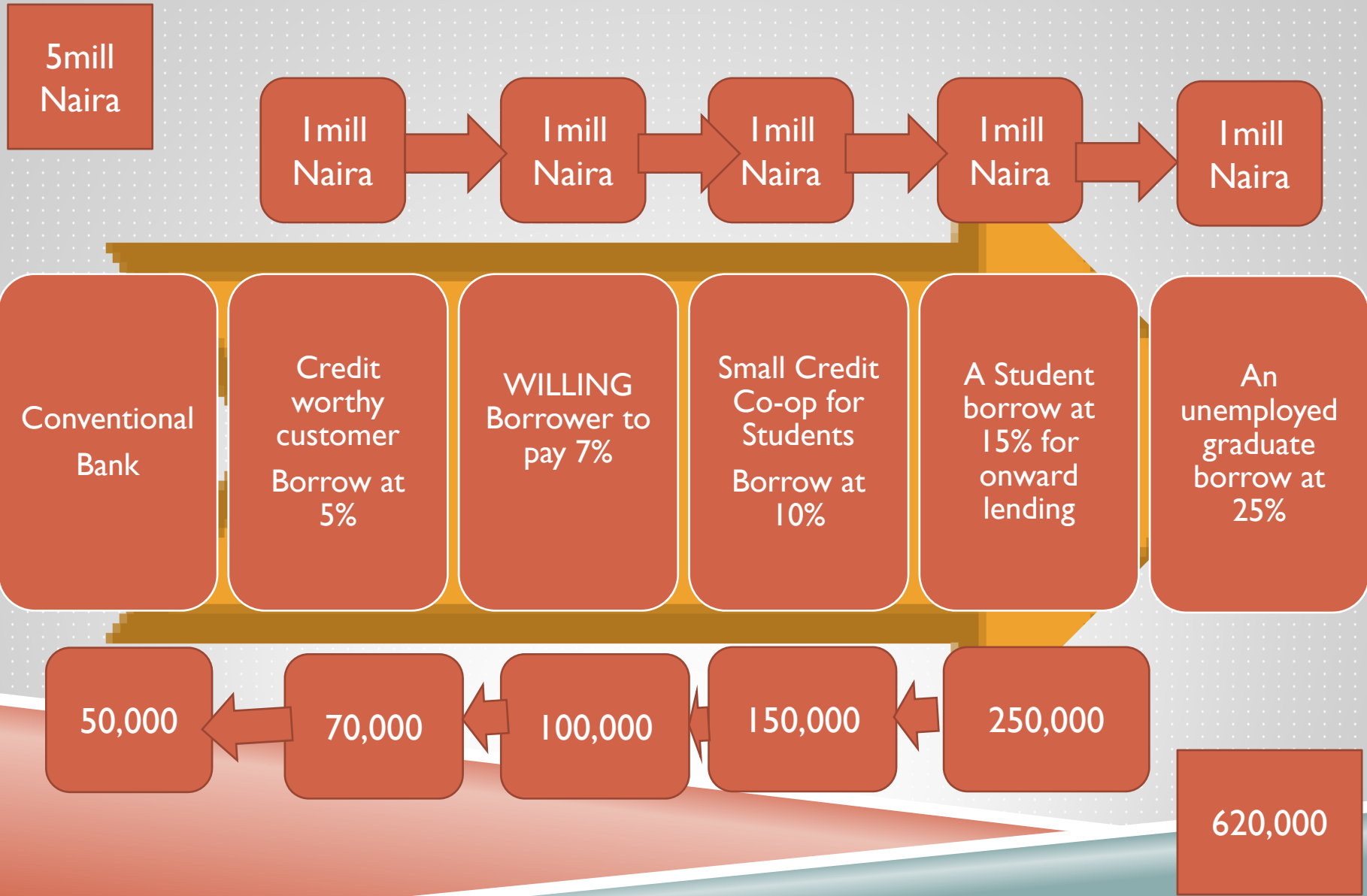
POSITION OF ISLAMIC FINANCIAL INSTITUTIONS IN ISLAMIC ECONOMIC SYSTEM



WHY ISLAMIC FINANCE?

- ❖ Islamic finance trade with money while Conventional finance trade in money
- ❖ Conventional finance transactions are interest based while Islamic Finance transactions are asset or service backed
- ❖ An asset or service cannot be compounded like interest based transaction
- ❖ An asset or service can only have one buyer or seller at any given time; whereas interest allows cash to circulate and grow into enormous sums
- ❖ Interest creates an artificial money supply that isn't backed by real assets resulting in increased inflation, heightened volatility, rich getting richer, and poor getting poorer

TRADING IN MONEY



BASIC PRINCIPLES GUIDING ISLAMIC BANKING & FINANCIAL TRANSACTIONS

- Be interest free
- Have risk sharing and asset and service backing
- Have contractual certainty
- And that all the elements of the transaction must, in and of themselves, be ethical

CHARACTERISTICS OF ISLAMIC BANKS

- ▶ Prohibition of interest
- ▶ Profit and loss sharing
- ▶ Low consumer lending
- ▶ High real sector investing
- ▶ Emphasis on Islamic principles of morality
- ▶ Low emphasis on collateral

SIMILARITIES BETWEEN ISLAMIC AND CONVENTIONAL BANKS

- ❖ Profit-making objective
- ❖ Nature **Of** banking services

- ▶ Current Account, Savings Account, **Investment**

Accounts [Term deposit], Clearing Mechanism, Bank Drafts, Bills of Exchange, Travellers Cheques, Letter of Credit, Collections, Remittance, Safe Deposits, etc.

- ❖ Bank's structure
- ▶ The Board of Directors

- ▶ **The Religious Supervisory** Board

- ▶ The Executive Committee
- ▶ Management

TYPE OF ACCOUNTS

❑ Demand Accounts

- Current Account
- Saving Account

❑ Investment Accounts

- General Purpose Investment Account
- Specific Purpose Investment Account

MODES OF FINANCING

- Equity based
 - Mudaraba,
 - Musharaka,
 - Sukuk
- Trade based
 - Murabaha
 - Salam, and Istisna
- Leasing based
 - Ijarahs

ANSWERING THE BIG QUESTION

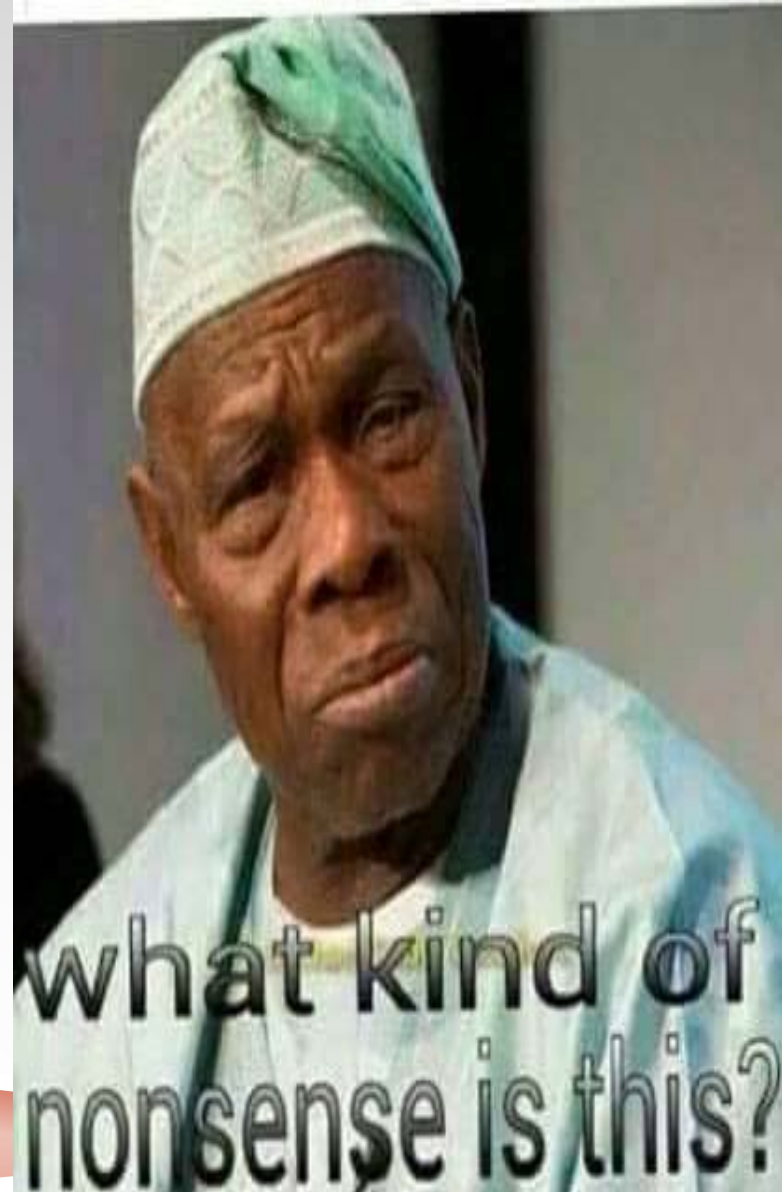
SHOW US HOW ISLAMIC
FINANCE IS DIFFERENT
FROM CONVENTIONAL
FINANCE

THE \$5BILLION LOAN

“All that we have borrowed up to 1985 or 1986 was around \$5billion and have paid about \$16billion, yet we are still being told that we owe about \$28billion. That \$28billion came about because of the injustice in the foreign creditors’ interest rates. If you ask me what is the worst thing in the world, I will say it is compound interest.”

President Obasanjo of Nigeria, G8 Summit, Okinawa 2000.

[quoted from Ethica’s Handbook of Islamic finance, 2013 edition]



THE \$5BILLION LOAN [40% INTEREST]

S/N	Year	Principal	Interest	Principal + Interest
1	1985	5,000,000,000	-	5,000,000,000
2	1986	5,000,000,000	2,000,000,000	7,000,000,000
3	1987	5,000,000,000	4,800,000,000	9,800,000,000
4	1988	5,000,000,000	8,720,000,000	13,720,000,000
5	1989	5,000,000,000	14,208,000,000	19,208,000,000
6	1990	5,000,000,000	21,891,200,000	26,891,200,000
7	1991	5,000,000,000	32,647,680,000	37,647,680,000
8	1992	5,000,000,000	47,706,752,000	52,706,752,000
9	1993	5,000,000,000	68,789,452,800	73,789,452,800
10	1994	5,000,000,000	98,305,233,920	10,330,523,3920
11	1995	5,000,000,000	139,627,327,488	144,627,327,488
12	1996	5,000,000,000	197,478,258,483	202,478,258,483
13	1997	5,000,000,000	278,469,561,876	283,469,561,876
14	1998	5,000,000,000	391,857,386,627	396,857,386,627
15	1999	5,000,000,000	550,600,341,277	555,600,341,277
16	2000	5,000,000,000	772,840,477,789	777,840,477,789

THE \$5BILLION LOAN [30% INTEREST]

S/N	Year	Principal	Interest	Principal + Interest
1	1985	5,000,000,000	-	5,000,000,000
2	1986	5,000,000,000	1,500,000,000	6,500,000,000
3	1987	5,000,000,000	3,450,000,000	8,450,000,000
4	1988	5,000,000,000	5,985,000,000	10,985,000,000
5	1989	5,000,000,000	9,280,500,000	14,280,500,000
6	1990	5,000,000,000	13,564,650,000	18,564,650,000
7	1991	5,000,000,000	19,134,045,000	24,134,045,000
8	1992	5,000,000,000	26,374,258,500	31,374,258,500
9	1993	5,000,000,000	35,786,536,050	40,786,536,050
10	1994	5,000,000,000	48,022,496,865	53,022,496,865
11	1995	5,000,000,000	63,929,245,924	68,929,245,924
12	1996	5,000,000,000	84,608,019,702	89,608,019,702
13	1997	5,000,000,000	111,490,425,612	116,490,425,612
14	1998	5,000,000,000	146,437,553,296	151,437,553,296
15	1999	5,000,000,000	191,868,819,285	196,868,819,285
16	2000	5,000,000,000	250,929,465,070	255,929,465,070

THE \$5BILLION LOAN [16% INTEREST]

S/N	Year	Principal	Interest	Principal + Interest
1	1985	5,000,000,000	-	5,000,000,000
2	1986	5,000,000,000	780,000,000	785,000,000
3	1987	5,000,000,000	1,681,680,000	6,681,680,000
4	1988	5,000,000,000	2,724,022,080	7,724,022,080
5	1989	5,000,000,000	3,928,969,524	8,928,969,524
6	1990	5,000,000,000	5,321,888,770	10,321,888,770
7	1991	5,000,000,000	6,932,103,418	11,932,103,418
8	1992	5,000,000,000	8,793,511,552	13,793,511,552
9	1993	5,000,000,000	10,945,299,354	15,945,299,354
10	1994	5,000,000,000	13,432,766,053	18,432,766,053
11	1995	5,000,000,000	16,308,277,557	21,308,277,557
12	1996	5,000,000,000	19,632,368,856	24,632,368,856
13	1997	5,000,000,000	23,475,018,398	28,475,018,398
14	1998	5,000,000,000	27,917,121,268	32,917,121,268
15	1999	5,000,000,000	33,052,192,186	38,052,192,186
16	2000	5,000,000,000	38,988,334,167	43,988,334,167

THE \$5BILLION LOAN: ANALYSIS

S/n	Year	40%	30%	16%
1	5 th	284%	186%	79%
2	10 th	1960%	960%	269%
3	16 th	15456%	5018%	780%

HOW WOULD ISLAMIC FINANCE HANDLE THE \$5BILLION LOAN

Using the \$5 billion example, Islamic banks could provide \$5 billion of financing for infrastructure, literacy, healthcare, or sanitation programs, to name a few.

- ▶ **Istisna:** An Islamic bank could have arranged for the \$4 billion construction of a natural gas pipeline and delivered it to Nigeria for \$5 billion using an Istisna
- ▶ **Musharaka or Mudaraba:** Or take an equity stake in a highway project and shared in profits and losses using Musharakah or Mudaraba
- ▶ **Murabaha:** Or purchased commodities and sold them at a premium using a Murabaha
- ▶ **Ijara/Sukuk:** Or structured a project financing using an Ijarah Sukuk.

MUDARABA

- ❑ A profit sharing contract, with one party providing 100% of the capital and the other party [the Mudarib] providing its expertise to invest the capital, manage the investment project, if appropriate, provide labour.
- ❑ Profit generated is distributed according to a predetermined ration, but cannot be guaranteed
- ❑ Losses accrued are borne by the provider of capital, who has no control over the management of the project
- ❑ Often used for investment funds, with investors providing money to the Islamic bank, which it invests as mudarib, taking a management fee

MUSHARAKA

- ❑ A partnership between two partners who both provide capital towards the financing of new or established projects
- ❑ Both parties share the profits on a pre-agreed ratio, with losses being shared on the basis of equity participation

MURABAHA

- ❑ A method of asset acquisition finance
- ❑ A contract between the bank and its client for the sale of goods at a price that includes an agreed profit margin, either a percentage of the purchase price or a lump sum
- ❑ The bank will purchase the goods as required by its client and will sell them to the client with a mark-up
- ❑ The profit mark-up is fixed before the deal closes and cannot be increased, even if the client does not take the goods within the time stipulated in the contract

IJARA

- ❑ A contract where the bank buys and leases out equipment required by the client for a rental fee
- ❑ Ownership of the equipment remains with the lessor bank, which will seek to recover the capital cost of the equipment plus a profit margin out of the rentals payable

DIMINISHING MUSHARIKAH

1 Year	2 Homebuyer's Purchase (N)	3 Bank's Equity (N)	4 Ownership Rent (N)	5 Homebuyer's Payment (N)
1	10,000	190,000	10,000	20,000
2	10,000	180,000	9,500	19,500
3	10,000	170,000	9,000	19,000
4	10,000	160,000	8,500	18,500
16	10,000	40,000	2,500	12,500
17	10,000	30,000	2,000	12,000
18	10,000	20,000	1,500	11,500
19	10,000	10,000	1,000	11,000
20	10,000		500	10,500

TAKAFUL [ISLAMIC INSURANCE]

- ❑ What is Takaful
- ❑ Basic Elements of Takaful
- ❑ Main Drivers of Takaful
- ❑ Takaful Models

COMPARING TAKAFUL TO CONVENTIONAL INSURANCE

Issue	Conventional Insurance	Takaful
Organization Principle	Profit for shareholders	Mutual for participants
Basis	Risk transfer	Co-operative risk sharing
Value Proposition	Profit maximization	Affordability and spiritual satisfaction
Laws	Secular/regulations	Sharia plus regulations
Ownership	Shareholders	Participants
Management Status	Company management	Operator
Form of Contract	Contract of sale	Cooperative, wakala, Mudaraba, with tabarru [contributions]
Investments	Interest based	Shariah compliant, riba-free
Surplus	Shareholders' account	Participants' account

CONVENTIONAL MORTGAGE: LOAN AMORTIZATION ASSUMPTIONS

1. Principal is N20,000,000
2. Period is 240 month [i.e. 20years x 12month]
3. Interest Rate is 15% [i.e. $15\%/12=0.0125$]
4. Monthly Payment is N263, 357.92 [this is gotten using the present value annuity formula, where $PV=20,000,000$, $r= 0.125$, $n=240$]
5. From month 2, the beginning balance is the previous month's ending balance

HOUSING LOAN AMORTIZATION SCHEDULE

Months	Beginning Balance	Interest Paid	Cumulative Interest	Principal Paid	Total Payment	Ending Balance
1	20,000,000	250,000	250,000	13,358	263,358	19,986,642
2	19,986,642	249,833	499,833	13,525	263,358	19,973,117
3	19,973,117	249,664	749,497	13,694	263,358	19,959,423
4	19,959,423	249,493	998,990	13,865	263,358	19,945,558
5	19,945,558	249,319	1,248,309	14,038	263,358	19,931,520
12	19,843,526	248,044	2,988,507	15,314	263,358	19,828,212
24	19,646,585	245,582	5,949,399	17,776	263,358	19,628,809
36	19,417,984	242,725	8,878,235	20,633	263,358	19,397,351
84	18,072,119	225,901	20,156,727	37,456	263,358	18,034,663
120	16,382,253	204,778	27,926,623	58,580	263,358	16,323,674
180	11,193,581	139,920	38,474,567	123,438	263,358	11,070,143
228	3,141,909	39,274	42,963,429	224,084	263,358	2,917,825
240	260,107	3,251	43,205,899	260,107	263,358	00.00

CAPITAL MARKET

- ❑ Islamic Funds
- ❑ Sukuk [Bond]
- ❑ Rating Agencies for Islamic Capital Market

THE CHRISTIAN WORLD VIEW OF ECONOMICS

“We affirm that God freely created all things and has the right and the power to rule all things, spiritual and physical, and that He is the ultimate owner of all things; that God sovereignly exalts whom He will and abases whom He will; that all men are accountable to God in all their activities; that God, through creation and decree, is the sole Author of many kinds of spiritual and material wealth, particularly individual and corporate existence, the existence of raw materials, and the operation of moral and physical laws governing the physical and spiritual universe; and that God sovereignly disposes of these to His creatures as He will.

[Psalm 24:1,2; John 1:1-3]

THE CHRISTIAN WORD VIEW OF ECONOMICS

“We affirm that all economic relations ought to be governed by justice; that justice means rendering impartially to each his due according to a right standard; that what is due to each is based on his conduct relative to the commands of Scripture and his service to others; and that the primary requirements of justice are revealed in the Ten Commandments and in the moral, civil, and judicial laws throughout Scripture that expand upon and apply the Decalogue”.

[Leviticus 19:15; Acts 10:34; Matthew 25:14-29;
Romans 3:31; 13:7]

REFERENCE

The Christian World View of Economics

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