ISLAMIC BANKING & FINANCIAL INSTRUMENTS

Islamic banking rests on a set of rules and laws collectively referred to as Shariah. Shariah governs not only financial aspects of Islamic society but also the social, political and cultural ones. The following basic principles characterize the Islamic financial system:

-The prohibition of interest; prohibition of "riba" as it is called is justified on arguments of social justice against speculation. Profits from labour and entrepreneurship are encouraged, whereas interest fixed or predetermined, irrespective of the performance of the business venture, distorts wealth creation and productivity.

-Risk sharing: the role of investor is emphasized as opposed to that of lender/creditor; both the provider of capital and the entrepreneur share risks and profits.

-Money is "potential" capital until it becomes actual capital in joining in a productive activity. The time value of money is admitted by Shariah but only when employed not as potential capital.

-Speculative behaviour is strictly prohibited especially in extreme uncertain transactions.

-Sanctity of contracts; upholding contractual obligations and disclosure of information are essential to reduce the risk of asymmetric information and moral hazard.

-Only Shariah-approved activities qualify for investment, i.e., no business dealings in alcohol, gambling or pork meat.

These underlying principles have thus forced Islamic finance to design special Islamic financial products/instruments:

> Mudaraba: a partnership profit-sharing agreement whereby capital is provided by the bank and assets, management or expertise by the client. The terms of profit and risk sharing are predetermined and customized for each investment. Any loss is borne by the bank except if negligence or misconduct can be proven on the part of the client. The maturity period being short to medium term, this instrument is generally suitable for trade activities.
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> Musharaka: a profit-sharing joint-venture between the bank and the client with both parties providing capital in equal or varying degrees and sharing the profits and losses in proportion to their investment. This form of equity participation is