

**10th Meeting of the Advisory Expert Group on National Accounts,  
13-15 April 2016, Paris, France**

**Agenda item: 9.2.1  
Islamic banking financial instruments**

Introduction

Islamic Finance refers to the provision of financial services in accordance with Shari'ah Islamic law, principles and rules. Shari'ah does not permit receipt and payment of "riba" (interest), "gharar" (excessive uncertainty), "maysir" (gambling), short sales or financing activities that it considers harmful to society. Instead, the parties must share the risks and rewards of a business transaction and the transaction should have a real economic purpose without undue speculation, and not involve any exploitation of either party. Islamic finance currently encompasses banking, leasing, Sukuk (securities) and equity markets, investment funds, insurance ("Takaful") and micro finance, but the banking and Sukuk assets represent about 95 percent of total Islamic finance assets.

This recent growth of Islamic finance has led to increased demand on the IMF. To foster its preparedness, the IMF has formed an Interdepartmental Working Group, with STA as a member, to develop an institutional view on the industry, build in-house expertise and better coordinate with different stakeholders; for further information see:  
<http://www.imf.org/external/themes/islamicfinance/index.htm>

As one outcome, this paper describes how Islamic financial institutions (IFIs) operate under the Islamic principles (Shariah) and how instruments they use differ from conventional financial instruments. It appears as an annex in the IMF *Monetary and Financial Statistics Manual and Compilation Guide*.

Documentation

Paper: Islamic Financial Institutions and Instruments

Main issues to be discussed

The AEG is requested to:

- Express its views on the recording of financial instruments of Islamic financial institutions

## Islamic Financial Institutions and Instruments

**4.256** This annex describes how Islamic financial institutions (IFIs) operate under the Islamic principles (*Shariah*) and how instruments they use differ from conventional financial instruments.<sup>1</sup> For the purpose of compiling monetary statistics, various types of Islamic financial instruments are discussed in comparison with those of conventional financial institutions.

### Islamic Financial Institutions

**4.257** The Islamic financial system refers to a financial system or financial activity that follows the principles of *Shariah*. *Shariah*, which denotes the Islamic law that governs the entire framework of activities in Islam, includes law regulating economic and financial activities in order to ensure fair transactions as well as social economic justice. Even though *Shariah* principles have existed throughout Islamic history, the application of *Shariah* principles in the modern Islamic financial system began with the establishment of Egypt's Mitt Ghamar Savings Bank in 1963, followed by the formation of the Islamic Development Bank (IDB) in 1973 and the Dubai Islamic Bank in 1975.

**4.258** The Islamic financial standard setting bodies, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)<sup>2</sup> and the Islamic Financial Services Board (IFSB), have made efforts to develop standards for IFIs, which include standards on accounting, audit, ethics, governance, *Shariah*, regulatory framework, capital adequacy, and risk management framework. These efforts are aimed at ensuring a safe and sound Islamic financial system (*Shariah* compliant) and to effectively integrate and harmonize the Islamic financial system and practices within the international financial system.

**4.259** Although both IFIs and conventional financial institutions are for-profit entities, their philosophy and operations are different, in that for IFIs *Shariah* prohibits financial transactions associated with: (1) interest (*Riba*) for lending and borrowing; (2) excessive uncertainty (*Al-Gharar*)—no contracts or contingents on the occurrence or non-occurrence of an uncertain future event; (3) speculation or gambling (*Al-Maisir*)—conversely, trading or transactions entailing a chance of gain or risk of loss are allowed. Commercial trade and investment for profit are acceptable and encouraged. IFIs use either trading models or profit and loss sharing models in financing customer's needs, participate in investments that meet *Shariah* principles, and earn fees for services rendered. For example, IFIs offer investors/depositors participation in risk-

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<sup>1</sup> This annex draws on Iqbal and Mirakhor (1987); Hanif (2014); and Accounting Standards of the Accounting and Auditing Organization for Islamic Financial Institutions.

<sup>2</sup> The AAOIFI is a standard-setting body for Islamic finance, which develops accounting, auditing, and *Shariah* standards. It was established in 1991 and is based in Manama, Bahrain. The IFSB, which is based in Kuala Lumpur, Malaysia, is a global standard-setting body for Islamic finance, which prepares prudential standards and guidelines for the regulation of Islamic banking, Islamic insurance (*Takaful*), and Islamic capital markets. It was officially inaugurated in November 2002, and started operations in March 2003.

bearing, open-ended, mutual fund-type packages or profit and loss sharing investment accounts, rather than fixed interest on deposits. In addition, *Shariah* prohibits financial transactions associated with businesses that produce goods and services considered contrary to its principles, like tobacco, alcohol, gambling, vulgar entertainment, etc.

**4.260** Several special types of deposits accounts and other financial instruments permit IFIs to engage in most of commercial banking activities although in a manner different from conventional financial corporations. Generally, any risk-bearing instrument reflecting a real asset and earning a rate of return tied to the performance of the asset is considered to be consistent with *Shariah*. Use of financial instruments with returns specified before investment is not permitted, but sharing of the returns by a pre-determined formula after the fact is acceptable. Some financial activities may have an established rate of return that could be created, for example, by the purchase and resale of goods at trade margins (cost plus profits) with deferred payments as a way of financing acquisition (called *Murabaha*). Generally, *Murabaha* is a dominant model of short-term financing in the portfolios of IFIs due to its easiness and low risk as compared with profit and loss sharing models of financing, even though other modes of financing such as leasing (*Ijarah*) and *Diminishing Musharaka* are also gaining more prominence.

**4.261** The functions of IFIs can be divided into the safeguarding of deposits and the partnership of financial institutions with shareholders and depositors (called investment account holders) in profit-making ventures. Demand deposit facilities (called *Qard*, *Wadiah*, or *Amanah* deposits) are similar to the safekeeping and transferable deposit functions performed in standard commercial banking. The *Qard*, *Wadiah*, or *Amanah* deposits pay no returns, and the IFI is obligated to preserve or guarantee the nominal value of the deposit. For purposes of compiling monetary statistics, Islamic deposit facilities should be treated in the same way as standard deposits in depository corporations (DCs).

**4.262** On the asset side, the activities of IFIs range from sale-based contracts to leasing and limited partnerships. The IFIs also make investments in equities, mutual funds, and medium- to long-term projects. To a large extent, IFIs act similarly to conventional intermediaries by issuing deposit-like instruments (such as profit and loss sharing deposits, unrestricted investment accounts, and profit sharing investment accounts (PSIA)) to the public in order to raise funds to finance commercial activity. The financing and investment activities of the IFIs are designed to expose both the investment account holders (IAH) and the IFIs to real economic activities on the ventures (profits or losses). Thus, the investments—of which many are negotiable and known by names such as “participation term certificates,” “profit and loss sharing (PLS) certificates,” and “investment deposit certificates”—have properties similar to those of shares in a company or a mutual fund.

**4.263** An IFI serving as an intermediary may act as a partner or as a provider of services in profit-making ventures and thus has some characteristics in common with mutual funds, financial leasing companies, or brokers. The restricted investment accounts offered by IFIs

are quite similar to mutual funds. Because of the joint participation between an IFI, shareholders, and IAHs in real economic activities, the IFI per se is not exposed to similar risks as is a conventional financial intermediary. In addition, the structure of the balance sheet of an IFI may differ from that of a standard conventional financial institution. For example, the equity capital base of an IFI may be larger than that of a conventional financial institution as it would also include the equity portion of IAHs in a separate component of equity; an IFI's financing portfolio may be concentrated in short-term trade instruments; and the nature of banking strategies and risks may differ.

**4.264** The prevailing statistical practice is to classify IFIs that have liabilities in the form of deposits or financial instruments that are close substitutes for deposits in the ODCs subsector. The implication of this practice is that most *PSIA* are treated in the same way as regular deposits for statistical reporting purposes. The participation of many IFIs in bank clearing systems and a concentration of financing activity in traditional, short- to medium-term commercial and trade financing are practices that tend to reinforce this classification.

**4.265** IFIs that are not primarily involved in deposit taking activities are classified as OFCs. IFIs investing mainly as long-term partners in business ventures are akin to non-money market investment funds, and are therefore classified within OFCs. IFIs mainly engaged in *Takaful* schemes, which is Islamic insurance, are classified as insurance corporations.

## Sources of Funds

**4.266** As financial intermediaries, IFIs—like conventional ODCs—issue deposits (current, savings, and fixed-term deposits) or deposit-like instruments as their sources of funds. The following list details sources of funds for IFIs.

- a. Qard, Wadiah, and Amanah deposits can be withdrawn on demand, at par, without penalty or restriction, and are generally usable for making payments by check, draft, giro order, or other direct payment facilities. These types of deposits are not linked to any profit-making ventures and are not part of the profit and loss sharing schemes, hence IFIs have the flexibility to use the funds but are required to guarantee the nominal value of the deposits. With the foregoing characteristics, these deposits usually offer no (or very small) returns to the depositors on the basis of gift (*hibah*). In the context of compiling monetary statistics, *Qard*, *Wadiah*, and *Amanah* deposits are classified as *Transferable deposits* if such deposits are directly usable for making payments by check, draft, giro order, direct debit, or direct payment facility. Otherwise, these deposits are classified as *Other deposits*.
- b. A Mudaraba, also known as PSIA, is a contract between investors and an IFI that, as a silent partner, invests the deposits in a commercial venture. Profit sharing of the venture is pre-determined on the basis of risk and return, and the IFI and investors share any profit generated from the venture. A *Mudaraba* can be entered into for a single investment or on a continuing basis with the IFI acting as a fiduciary. There

are two types of *Mudaraba* investment accounts according to the AAOIFI FAS No. 27 (*Investment Accounts*), namely *Unrestricted Mudaraba* and *Restricted Mudaraba*. *Unrestricted Mudaraba* is where the investor fully authorizes an IFI to invest the funds without restrictions as to where, how, and for what purpose the funds should be invested as long as it is deemed appropriate. Mixing of funds from other sources (including shareholders' funds) is permitted and separate disclosure in the financial statement is therefore required. *Restricted Mudaraba* is where the investor restricts the manner as to where, how, and for what purpose the funds are invested. No mixing of funds is allowed from other sources to ensure proper management and accountability of the funds. A separate disclosure (off-balance sheet) in the form of *Statement of Restricted Mudaraba* is required to be kept by the IFIs. Similar to the case of deposits at conventional financial institutions, *Unrestricted Mudaraba* can be divided into the following types:

- *Mudaraba* accepted without a time frame (not fixed). The investors are free to withdraw their money at any time, and hence this type of *Unrestricted Mudaraba* is similar to those of savings deposits at conventional financial institutions and is classified as *Other deposits*.
  - *Mudaraba* accepted for a fixed period that provides opportunity for IFIs to invest in more profitable long-term projects. This type of *Unrestricted Mudaraba* is similar to time deposits at conventional financial institutions and usually generates higher profits in comparison to the former type. For compiling monetary statistics, this type of *Unrestricted Mudaraba* is classified as *Other deposits*.
  - *Mudaraba* accepted for fixed terms and arranged through negotiable instruments (called investment deposit certificates or *Mudaraba* certificates). This type of *Unrestricted Mudaraba* has characteristics similar to those of debt securities and is classified as a *Debt security* unless it provides a claim on the residual value of the issuing entity, in which case it is classified as *Equity*.
- c. Qard-hasan deposits are return-free deposits voluntarily placed by depositors, to participate in the financing for needy individuals or for social purposes. This type of deposit is classified as Other deposits in the compilation of monetary statistics.
- d. Zakah funds, according to the AAOIFI FAS No. 9 (Zakah), are special funds that are maintained by IFIs, used for social purposes, and financed by contributions from depositors and IAHs. Zakah funds are not part of the financial institution's sources of funds for financial intermediation, and are usually recorded as off-balance sheet items by IFIs. If Zakah funds are collected and organized as separate nonprofit institutions (NPIs), for example "Zakah houses," these institutions will record Zakah funds on their balance sheets, and should be classified as nonprofit institutions serving households (NPISHs), if they are not controlled by government. By their

nature, “Zakah houses” are nonmarket NPIs because they do not charge for their services. If controlled by government, these Zakah funds should be classified as government units.

- e. Participation term certificates are long-term investment instruments that entitle the holder to a share of a corporation’s profit. These certificates should be classified as Other deposits if the certificates are treated as debt liabilities of an IFI, and as Equity if part of the capital base.
- f. Profit and loss sharing certificates and investment deposit certificates, such as Mudaraba certificates, are investors’ deposits that somewhat resemble shares in a company but do not provide a claim on the residual value of the IFI and participation in its governance. These instruments should be classified as Other deposits. If Mudaraba certificates are negotiable, they should be classified as Debt securities.
- g. Sukūk, also known as Islamic bonds and considered as alternative to conventional bonds, are investment certificates issued by IFIs as a way to obtain funding. According to the IFSB-15 (Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services), Sukūk (plural of sakk) are certificates, with each sakk representing a proportional undivided ownership right in tangible and intangible assets, monetary assets, usufruct, services, debts or a pool of predominantly tangible assets, or a business venture (such as Mudaraba or Musharaka). These assets, which must be clearly identifiable, may be related to a specific project or investment activity in accordance with Shariah rules and principles. Issuance of Sukūk, including the utilization of funds raised through such issuance, should not involve any elements of interest (Riba), excessive uncertainty (Gharar), or activities prohibited by Shariah. The following three types of Sukūk contracts are the most prominent: (1) Sukūk Ijarah, (2) Sukūk Musharaka, and (3) Sukūk Murabaha, which are all negotiable instruments, except that Sukūk Murabaha becomes negotiable only when certain conditions are met. In recent years, Sukūk have become very popular as an alternative means of raising funds for government through sovereign issues. A distinguishing feature of Sukūk is that the holders are entitled to share revenues generated by the Sukūk assets and are entitled to a share in the proceeds of the realization of Sukūk assets. Hence Sukūk holders claim an undivided beneficial ownership in the underlying assets. Governments, central banks, financial or nonfinancial corporations, and supranational organizations can issue Sukūk. For the purpose of compiling monetary statistics, Sukūk should be classified as Debt securities, unless the owner of the security has a claim on the residual value of the issuing entity. For further details on the classification of Sukūk by type of underlying contract, see Annex 3 in the Handbook on Securities Statistics.

## Uses of Funds

**4.267** On the assets side, IFIs invest money collected from investors in some commercial ventures by using either trading models or profit and loss sharing models. The following list covers the primary types of financing provided by IFIs:

- a. Qard-hasan is a return-free financing that is made to needy individuals or for some social purpose. Qard-hasan financing is usually extended on a goodwill basis, and the debtor is required to repay only the principal amount of the financing. The debtor may, however, at his or her discretion, pay an extra amount beyond the principal of the financing (without promising it) as a token of appreciation to the creditor. Qard-hasan financing is classified as Loans.
- b. Murabaha financing, according to the AAOIFI FAS No. 2 (Murabaha and Murabaha to the Purchase Orderer), is defined as a sale of goods at cost plus an agreed profit margin. A Murabaha sale in the preceding context means the selling of a product owned by the seller at the time of entering into a contract. In a Murabaha contract, an IFI purchases goods upon the request of a client, who makes deferred payments that cover costs and an agreed-upon profit margin for the IFI. The IFI handles payments to the supplier including direct expenses incurred (delivery, insurance, storage, fees for letter of credit, etc.). Operating expenses of the IFI are not included. Under Murabaha contracts, disclosure of cost of the underlying goods is necessary. Murabaha contracts resemble collateralized loans of the conventional financial institutions, in which the underlying goods, such as properties or automobiles, are registered under the customer's name and are used as collateral. In compiling monetary statistics, Murabaha should be classified as Loans.
- c. A Bai Muajjal is a type of financing provided by an IFI to its client by supplying desired commodities or services with deferred payments. In compiling monetary statistics, a Bai Muajjal is classified as Loans given that the supplied commodities or services are from third parties.
- d. A Bai Salam financing, according to the AAOIFI FAS No. 7 (Salam and Parallel Salam), is a shortterm agreement in which an IFI makes full prepayments (spot payment) for future (deferred) delivery of a specified quantity of goods on a specified date. In practice, farmers usually need money to purchase seeds and fertilizers. An IFI and farmers in this case may engage in a Bai Salam contract, in which farmers agree to sell their crops to the IFI prior to harvesting. Generally, the agreed spot price is less than the future price of the commodities, in order for the IFI to make profits. A Bai Salam should be classified as Loans, given that the produced crops are not for the IFI's own use.
- e. An Istisna'a financing, according to the AAOIFI FAS No. 10 (Istisna'a and Parallel Istisna'a), is a partnership between an IFI and an enterprise, usually manufacturer or



construction company, in which the IFI places an order and provides financing to the enterprise to manufacture/construct and or supply certain goods or buildings. Upon or before the delivery of the order, IFIs usually engage into a contract with another party (the ultimate purchaser) at a price higher than the original contract of the Istisna'a, thus generating profits for the IFI. As a matter of practice, an Istisna'a is classified as Loans, given that the produced goods or constructed buildings are not for the IFI's own use, but for the ultimate purchaser. If the goods or buildings are for the IFI's own use, an Istisna'a is classified as Trade credit and advances within Other accounts receivables.

- f. An Ijarah is a lease-purchase contract in which an IFI purchases capital equipment or property and leases it to an enterprise. The IFI may either rent the equipment or receive a share of the profits earned through its use. According to the AAOIFI FAS No. 8 (Ijarah and Ijarah Muntahia Bittamleek), there are two types of Ijarah, namely Operating Ijarah and Financing Ijarah (Ijarah Muntahia Bittamleek or Ijarah Wa Iktina). Under Operating Ijarah, the title for the underlying asset is not transferred to the client (lessee), and ownership risks of the assets are borne by the IFI; expenses related to the use of the assets are the responsibility of the client. A Financing Ijarah involves two contracts (i.e., a lease over the lease period and transfer of ownership at the end of the contract). For compiling monetary statistics, an Operating Ijarah should be treated in the same way as a conventional operating lease. Financing Ijarah, which resembles a conventional financial lease, should be classified as Loans.
- g. A Musharaka financing, according to the AAOIFI FAS No. 4 (Musharaka Financing), is a partnership between an IFI and an enterprise in which both parties contribute to the capital (*rab al maal*) of partnership. In a Musharaka partnership, the IFI and client agree to share any profits generated from the venture according to the pre-agreed ratio; a loss is shared according to the ratio of contribution. In the context of compiling monetary statistics, a Musharaka financing is classified as Loans, provided the IFI does not acquire a claim on the residual value of the enterprise.<sup>3</sup>
- h. A Mudaraba financing, according to the AAOIFI FAS No. 3 (Mudaraba Financing), is a partnership between an IFI and a client in which the IFI provides capital (*rab al maal*) and the client provides skillful labor. *Mudaraba* financing is a type of partnership whereby skill and money are brought together to conduct business. Profits generated from the business are shared according to the agreement, while losses are borne fully by the IFI as the capital provider, except when losses were due to misconduct, negligence or violation of the agreed conditions by the client. In the context of compiling monetary statistics, a *Mudaraba* financing is classified as

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<sup>3</sup> *Musharaka* financing can be structured in two possible ways according to Islamic scholars: (1) *Musharaka* financing offered as a loan where the IFI provides financing in the form of working capital to an entity but does not have a claim on the residual value of the debtor entity; and (2) *Musharaka* financing offered as equity participation.



*Loans*. Although *Mudaraba* financing has features of equity, it has a fixed-term nature and therefore represents a fixed-term claim on the client rather than a claim on any residual value.

### **Takaful as a Form of Insurance**

**4.268** A Takaful is Islamic insurance that has emerged to complement IFIs, as an alternative form of conventional insurance. *Takaful* was invented as an Islamic way of mutual assistance to deal with uncertainties (*Al-Gharar*). As in the case of conventional insurance, *Takaful* deals with both life and nonlife (general) insurance.

**4.269** *Takaful* undertakings and Islamic societies in different parts of the world are now practicing *Takaful* schemes based on the concept of pooling risks, which does not contradict the *Shariah* principles. *Takaful* helps participating members in sharing financial responsibilities to assist each other. The compensation to the unfortunate member and group responsibility are not only accepted, but also encouraged in Islam. The growth of *Takaful* companies not only would serve as the vehicle of risk pooling, but also as alternative means of investment.

**4.270** In the context of compiling monetary statistics, if a *Takaful* company meets the definition of insurance corporations as described in paragraph 3.189, it should be classified as an *insurance corporation*. Its claims and liabilities related to *Takaful* (i.e., participants' contributions, or *Tabarru*), *Re-Takaful* contributions, and claims or compensations related to the *Takaful* policies, should be classified as insurance (included in the financial instrument *Insurance, pension, and standardized guarantee schemes*).