

Islamic Financial System – A Way Forward

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Abstract

The contemporary world, as experienced from a rational perspective, is in a total state of chaos. Be it the family system, political system or the social system, the disintegration is all pervasive as the intrinsic fabric of the politico-socio-economic setup affecting every individual's life stands essentially compromised. The reason for such a virtual pandemonium, as seen from an Islamic prism, happens to be the abandonment of the divine guidance. With the modern economic system being no exception to an intriguing sphere of the vicious pillars of interest, gambling, and speculation, the Muslims across the globe, willingly or unwillingly, are falling prey to the disobedience of Almighty Allah and his Prophet (Sallahualaihi wasallam). The clear guidance of the Holy *Qur'an* regarding the prohibition of interest (*riba* or usury) made it indispensable for the Muslim world to alternate the conventional financial system with the one that is enacted on the principles of justice, equity, and fairness. As a consequence, an alternative system of financial intermediation and asset mobility, commonly referred to as Islamic Financial System (IFS), came into existence. The IFS being relatively novel to the modern world requires significant research attention from all concerned quarters. As such, an attempt has been made in this paper to elucidate the concept and fundamentals of the IFS that render it advantageous over the conventional financial system. Moreover, while explaining the technicalities of a financial system, the paper tries to assume a lucid orientation to facilitate a better understanding. The present paper has only dealt with the conceptual dimension of Islamic financial system, the application of such concepts under the contemporary economic scenario does not fall within the purview of this paper.

Introduction and Background

The foundation of transactions based on Islamic guidelines was essentially laid in the 7th century when the Prophet (*Sallahualaihi*

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wasallam) himself used to carry out business in accordance with the Sharia principles. However, the pre-modern Islamic world lacked a comprehensive financial system as the one that is present today. But at the same time, it cannot be established that Islamic world operated without a financial sector at that time. Contrary to the opinion of De Roover (1954) which says “there can be no banking where there are no banks”, Udovitch (1979) argues “this proposition may hold true for the development of banking in medieval Europe but it certainly does not describe the medieval Islamic world...”. Moreover, several of the historical writings by al-Qalqashandi (1913), al-Djahshiyari (1938), al-Kubaisi (1979), al-Sa’di (1985), Fischel (1992) even argue the existence of bankers called *sarraffeen* or *sayarifah* or *jahabidhah* during the above stated period.

Lieber (1968) pointed out that “Among Muslims, international trade was particularly stimulated by the pilgrimage to the holy places of Arabia, in which a great body of men converged each year from all over the world. Many of these pilgrims fulfilled their religious obligations and at the same time, marketed their local products along the route, returning home with foreign goods on which they hoped to make a handsome profit.” While trade across different tribes began to develop, newer innovations in banking operations accompanied. These included lending, transferring, guaranteeing, borrowing etc. However, these services were present in a relatively unstructured form, being offered by common moneylenders or landlords.

In the modern sense of banking, the origin of Islamic banking traces back to 1960s or early 1970s as a result of some of the Muslim economists envisioning an alternative form for the conventional western economics. The reason being that most of the Muslim countries in the world were under the influence of western form of banking and finance, either directly or indirectly (Vogel & Hayes, 1998). Resultantly, the traditional practices of economics based on Islamic rules were diminishing at a very significant pace. As a consequence, the need for creating a system that would offer complete package of banking services without violating the Sharia principles was felt across the Muslim world. This wave traces its

roots to 1940s and 1950s when some of the colonized Islamic countries achieved independence.

The above stated scenario paved way for the establishment of the first Islamic bank in rural Pakistan in late 1950s (Traute, 1983; Wilson, 1983). It was founded by a small group of landowners trying to avoid interest (*riba*). The money deposited with the bank was advanced for agricultural purposes. Interest was not charged from borrowers for credit, but a menial administrative fees was levied to run the operations of the bank. However, this bank did not have a lasting impact mainly because of the lack of autonomy of the bank as depositors were over interested in the functioning in the bank, and secondly the problems of recruitment of staff surfaced with most of the people not willing to sacrifice lucrative jobs in conventional banks for a relatively uncertain establishment. Consequently, the bank collapsed.

A more significant attempt to create an Islamic bank was made in Egypt in 1963. It was 25th July, 1963 when the Mit-Ghamr Islamic Savings Bank (MGISB) was established in the county of Mit-Ghamr in Egypt. This pioneering experiment was conducted by el-Naggar, who primarily was an academic but ended up as the Secretary General of International Association of Islamic Banks besides being the founder manager of the MGISB. The purpose was to uphold the principles of Sharia besides providing a platform for asset mobilization and financial intermediation. According to Wilson (1983), the peasants showed enthusiastic support towards this bank because of being suspicious about the outside banks, which they believed were created to serve the westerners and/or Egyptians with western orientation. Since that time the Islamic financial industry has experienced an unprecedented growth from being just a niche player with not even a national presence to a complete financial system running parallel to the conventional financial system.

Growth of Islamic Financial Industry

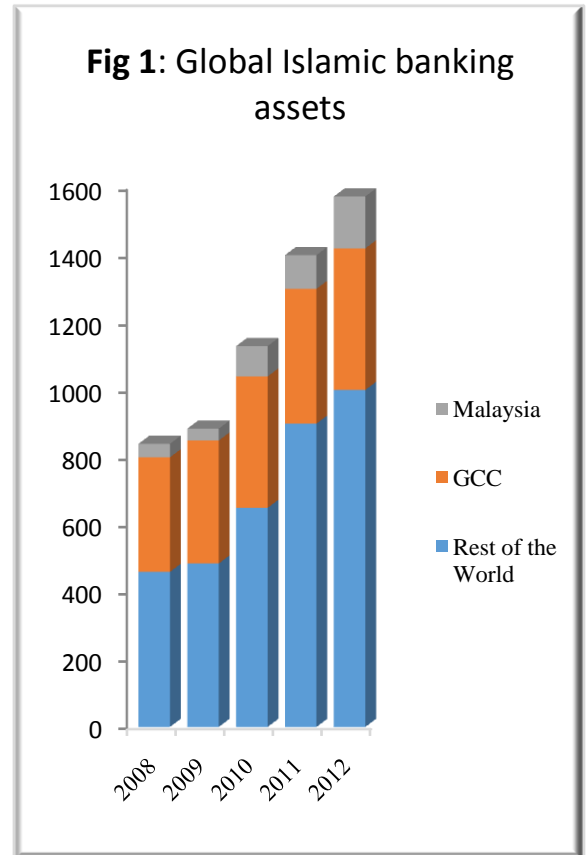
A brief outlook of the timeline reflecting significant advancements in the Islamic financial system is given here under.

- The year 1975 marked the internationalization of Islamic finance with the establishment of Islamic Development Bank in Saudi Arabia. It facilitated economic development by recruiting member countries and offering them Sharia compliant financial products.
- In the year 1979, the Islamic Insurance Company of Sudan was established. It was the first Islamic insurance (or *Takaful*) company. *Takaful* is an Islamic alternative to conventional insurance products as the later involves uncertainty, gambling etc.
- The first Islamic mutual fund of the world was established in Indiana in 1986-The Amana Income Fund. It invested only in Sharia compliant equities.
- With the objective to establish accounting and auditing standards, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was created in 1990. In the same year, the first tradable *Sukuk* were issued by Shell MDS in Malaysia. It served as an alternative to conventional bonds.
- In 1996, large scale conventional banks marked their presence in Islamic finance industry when Citibank began to offer Islamic banking services by establishing the Citi Islamic Investment Bank in Bahrain.
- In 1999, the Dow Jones Islamic Market Index (DJIMI) was established. It became the first successful benchmark for the performance of Islamic investment funds.
- Three years later, in 2002, Islamic Financial Services Board (IFSB) was established in Malaysia. It served as an international body to set the standards for Islamic financial institutions.
- The first Islamic bank to be established outside the Muslim world was the Islamic bank of Britain. It was established in 2004.
- Between 2004 and 2008, investors showed strong orientation towards Islamic finance products amid rise in the global oil prices.
- In 2006, the Dubai Financial Market, the main stock exchange of Dubai announced that it is restructuring itself to enter into the ambit of Islamic financial system.
- The year 2008 sent the conventional banking system into doldrums with experts across the globe stressing the systemic faults prevalent in the interest-based economic system. This provided a

propelling effect to the Islamic finance as a viable and effective alternative.

- In order to compete for the market share of Malaysia, Singapore launched its first ever Islamic bond program in January, 2009. A month later in the same year, Indonesia sold its first Sharia-compliant bond (*Sukuk*).

Furthermore, in its Islamic Banking competitiveness report 2013-14, Ernst & Young (E&Y) estimated that the Islamic banking assets grew at the rate of 17.6% between 2009 and 2013, a growth rate that is almost thrice as compared to that of conventional banks. It further reported that the Islamic banking assets will continue to grow at an average of 19.7% from 2013 to 2018. In terms of Return on Equity, Islamic banks are not far too behind from their conventional counterparts. In 2012, the ROE for 20 leading Islamic banks (on an average basis) has been 12.6% as against 15% for comparable conventional banks. Apart from that, the global Islamic banking assets, presently, stand at around \$2 trillion. Nearly 80% of the same, according to Malaysia’s central bank, is entrusted with either the Islamic banks or the Islamic units of conventional banks. The rest is in the form of Sukuk (15%), Islamic investment fund (4%), and Takaful (1%). A graphical representation of the global Islamic banking assets

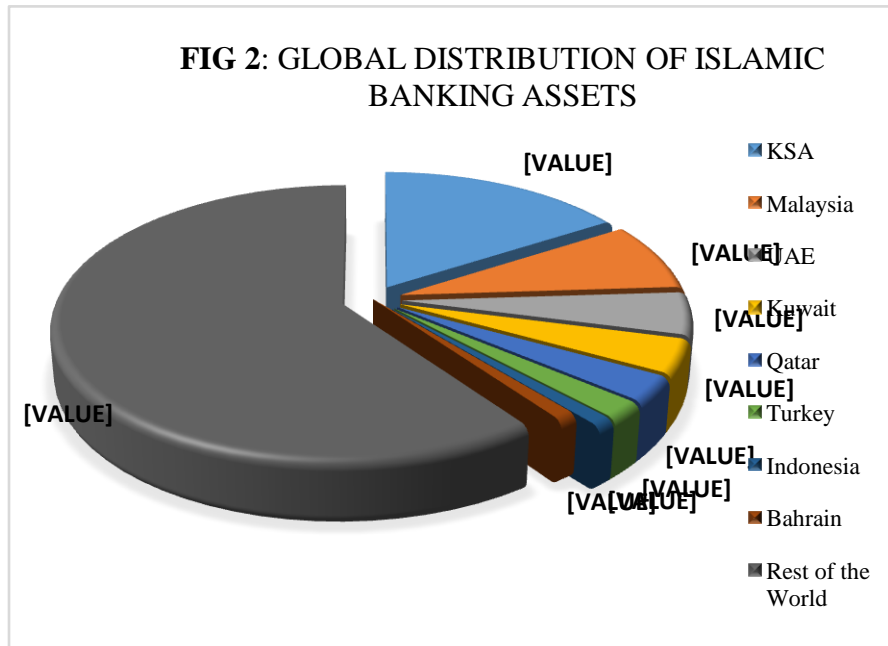


is shown in Fig 1 above.

Source: Islamic Banking competitiveness report 2013-14 (E&Y)

Furthermore, as per the data of 2012, Iran accounts for nearly half of the Islamic banking assets (41%) followed by Saudi Arabia (12%) and Malaysia (10%). For the

future internationalization of Islamic banking industry, QISMUT (Qatar, Indonesia, Saudi Arabia, Malaysia, UAE, and Turkey) nations are of strategic importance as out of the 38 million customers that Islamic banking industry caters presently, two-thirds reside in QISMUT countries. Also, the QISMUT constitutes 78% of the international Islamic banking assets. With a 5-year CAGR of 16.4% (2008-2012), they are regarded as the six rapidly growing markets (RGMs) for Islamic financial industry. The global distribution of Islamic banking assets is shown in Fig 2.



Source: Islamic banking competitiveness report 2013-14 (E&Y)

Concept and Foundations of Islamic Financial System

The entire system of Islamic economics revolves round the belief in the divine guidance. Muslims have a firm belief that Islam is not only restricted to certain rituals, teachings of morality and individualistic values. Rather Islam provides a complete code of conduct that governs every sphere of life with the socio-economic system being no exception. The reason for providing a complete set of guidelines rests in the fact that human rationality is subject to making errors especially beyond certain limits. For example, the

fallacy of quite a large number of theories of the past has been proven in modern times. Although, at their respective times, all such theories were treated to be sound and genuine. Moreover, there is every apprehension that human 'reason' may be confused with 'unhealthy desires' when human greed operates in the guise of rational decision making. Hence, for the sake of preserving the collective good of the society and to prevent injustice in the creation and distribution of economic benefits, the entire platform of financial decision making has not been left solely at the mercy of limited rationality of human mind. Given this premise, an attempt to create a complete system of economic activity has been underway for the past five decades or so which rests on the divine guidelines of the Holy *Qur'an* and the *Sunnah* of Prophet Muhammad (*Sallahualaihi wasallam*). Such a system is technically referred to as Islamic Financial System (IFS).

Islamic Financial System (IFS) operates with the principle of prohibition of interest (*riba or usury*), hoarding, short sales, gambling, speculative transactions, and dealing in unlawful goods and services. These prohibitions are meant for the purpose of maintaining economic balance, ensuring distributive justice and equal access to opportunities. The various products that Islamic financial industry offers as an alternative for conventional banking products are briefly explained as follows.

Musharakah

In its literal sense, the word *Musharakah* means "sharing". In the context of business, *Musharakah* can be interpreted as a joint venture wherein all the partners share both profits as well as losses. It operates against the conventional form of financing in which loan is advanced on the basis of a predetermined rate of interest.

The guiding principle for a *Musharakah* contract is to prevent the industrialists from making undue profits out of the money advanced by financiers. Since under the conventional system of loan advancing, the financier is entitled to a predetermined fixed rate of interest irrespective of the rate of return generated by the borrower on the project for which the money has been advanced. This mechanism acts as a double-edged sword. It certainly harms

either the financier or the user of funds. If the user generates above normal return on the funds, it will be unjust on his part to pay only a meagre fixed amount of interest to the financier and absorb the maximum benefit. On the other hand, if losses are incurred on the project, the borrower is still required to pay the interest amount due to the financier, which again amounts to injustice on part of the financier.

On the contrary, under a *Musharakah* contract a financier advances money with no fixed rate of interest, instead he/she acts as a partner and shares both the profit and loss arising out of the project. This implies, higher the profits accruing from the project, higher the return to the financier. At the same time, if the project incurs losses, the financier has to share the same as well, without putting the entire burden of loss on the borrower of funds. This kind of mechanism favors the principle of distributive justice and also prevents disparity in the distribution of wealth.

Some of the basic rules that govern the *Musharakah* contracts are outlined as follows:

- *Musharakah* is contractual relationship between parties hence all the essentials of a valid contract must be fulfilled e.g. free consent of the parties, legality of the object, competence of the parties to enter into a contract etc.
- The ratio in which profit is to be distributed between the parties must be decided at the very outset i.e. at the time of entering into the contract. The *Musharakah* contract is not valid in case this principle is not followed.
- The distribution of profit amongst the partners is dependent on the amount of profit earned. It should not be pegged to the amount invested by the partners.
- The ratio of profit to any partner may not necessarily conform to the ratio of his investment under normal conditions. However, a sleeping partner's share of profit cannot exceed the ratio of his investment.
- The losses are to be shared exactly according to the ratio of investment.

- The share capital to be contributed can take either a cash or kind form. In the latter case, the share capital of the partner is determined by the market value of the commodities contributed.

Mudarabah

Mudarabah is a type of contract wherein the entire amount of investment in a commercial project is made by only one party, known as '*rabb-ul-mal*', and the management of the enterprise is the sole responsibility of the other party, called as '*mudarib*'. The *Mudarabah* contract can be classified into two categories. 1) *al-Mudarabah al-muqayyadah* (restricted *Mudarabah*), which means that the *rabb-ul-mal* has laid down a restriction for *mudarib* to invest the money only in a specific kind of business. The later has no right to violate the restriction. 2) *al-Mudarabah al-mutlaqah* (unrestricted *Mudarabah*), refers to the situation where the *mudarib* enjoys a free will to invest the money in any kind of business that he deems suitable. Needless to mention here that the business should be a legal one i.e. it should not involve gambling, liquor etc. Like in case of a *Musharakah* contract, predetermined rate of distribution of profit is essential for a *Mudarabah* contract to be valid. However, unlike *Musharakah*, there is no restriction for the parties with regards to the ratio of profit distribution. Rather, it has been left to the mutual consent of *rabb-ul-mal* and the *mudarib*. However, assigning a lump sum amount to any party is not allowed and the ratio of profit to *rabb-ul-mal* cannot be tied up with the amount of capital invested by him. Moreover, the *mudarib* is not entitled to any salary or remuneration for the efforts put in by him. However, a relaxation has been allowed by *Hanafi* jurists that in case the *mudarib* leaves his home town for a business trip, then he can claim the expenses for food, accommodation etc.

Murabahah

Murabahah refers to a particular type of sale transaction wherein the cost of commodity to be sold must be necessarily disclosed to the buyer. This implies that a simple transaction of sale can be effected as a *Murabahah* only by making the buyer aware of the cost of the product and, by default, the subsequent

amount/percentage of profit charged by the seller. When the seller conceals the cost of product or when the cost of product cannot be ascertained, the sale is known as *Musawamah*. *Murabahah* provides the scope for both 'spot' sales as well as 'deferred' payment.

Needless to mention that all the essential elements of a valid sale must be present in a *Murabahah* also e.g. the subject of sale must be existing, in the ownership of seller, in the constructive possession of seller, a property of value, an item used for nothing but only for halal purpose, specifically identified to the buyer etc. Apart from these basic elements of sale, a *Murabahah* sale can be effected with the following guidelines.

- Even at the cost of repetition, it is essential to mention that the seller needs to disclose the cost he has incurred on the product.
- Mutual consent between the seller and buyer determines the amount of profit to be charged.
- The expenses directly attributable to the product e.g. custom duty, freight etc. are allowed to be included in the cost of the product. But the indirect expenses like the salaries of employees, electricity bills, rent etc. should not be added to the cost. The same are taken care of by the profit margin.
- If the exact cost of a commodity cannot be ascertained, such kind of product cannot be sold under *Murabahah*.

Ijarah

From the perspective of Islamic *fiqh*, the term *Ijarah* means 'to give something on rent'. However, there are two different connotations of *Ijarah* in the literature on Islamic jurisprudence. The first one refers to the employment of services of a person in consideration to wages paid for the services rendered by him. The one who delivers services is called *ajir* and the employer is known as *musta'jir*. The wages paid are called *ujrah*.

The second category of *Ijarah* means to transfer the usufructs of a particular asset to another person in consideration for a rent. This type of *Ijarah* stands analogous to the concept of 'Leasing'. In this case the lessor is known as '*mu'jir*', the lessee is known as '*musta'jir*' and the rent received from the lessee is called as *ujrah*. Although, both types of *Ijarah* are used by people around the

world, however, the second type of *Ijarah* is more relevant in the context of modern financing.

The following text provides a brief note on the rules governing the *Ijarah* contract.

- Any commodity that does not have a valuable use cannot form the subject of *Ijarah*. Moreover, it is essential for a valid *Ijarah* that the ownership right of the property remains with the lessor and only its usufruct is transferred to the lessee. It signifies, by default, that any consumable commodity (e.g. fuel, eatables etc.) cannot be a subject of *Ijarah*.
- The liabilities attributable to the ownership of the property must be borne by the lessor, while the ones pertaining to the use of the subject of *Ijarah* are to be assumed by the lessee.
- The lease period must be pre-determined.
- For any damage to the subject of *Ijarah* caused by the negligence of lessee, he is liable to compensate the lessor for the same. However, if the damage results from any factor(s) beyond the limit of lessee, the loss is to be borne by lessor.
- The amount of rent must be determined in advance for the entire period of contract. The lessor has no right to alter the rental unilaterally.

Salam and Istisna'

The general rule in Sharia for a sale agreement to be valid is that the commodity (to be sold) needs necessarily to be in the physical or constructive possession of the seller. However, Islamic jurisprudence allows *Salam* and *Istisna'* as the two exceptions to this general rule. These are discussed as follows:

Salam

If a seller undertakes, against a fully paid price on spot, to supply goods of specified quality and quantity to the buyer on a specified future date then such a contract is called *Salam*. As a general rule, forward sales are prohibited by Islam, however, *Salam* is allowed as an exception. The price of the commodity must be paid in full by the seller at the time entering into the contract. Payment in installments will render the *Salam* invalid. Moreover, *Salam* cannot

be effected for those products wherein the exact quality and quantity cannot be specified.

Istisna'

Istisna' refers to the order placed by the purchaser with a manufacturer of goods for the purchase of a specific commodity. Once the order is placed the manufacturer then commences the production of the good. It is evident that at the time of order placement, the commodity is non-existent and as such *Istisna'* operates as an exception to the general rules of sale. Before the work is commenced on the manufacture of commodity, both the parties enjoy a right to terminate the contract with a notice to the other party. However, after the commencement of work, the contract cannot be terminated unilaterally.

Epilogue

As has been outlined in the paper, Islamic Financial System has evolved from a relatively unstructured organization of landowners to a complete mechanism of operational procedures for economic activity. It essentially provides a genuine platform for financial practices that run within the ambit of Islamic jurisprudence. Furthermore, given the economic tumult of 2008 that sent the conventional financial system into a tailspin, economists across the borders are found groping for answers to the mysteries of economic fundamentals. There are certain systemic faults inherent in the interest-based financial system that prevents economists and policy makers to arrest the perennial problems of inflation, unemployment etc. Consequently, IFS presents a genuinely viable alternative that amongst other things is potentially capable of ensuring equitable distribution of wealth. This, in effect, can reduce, if not eliminate, the financial disparity that is conspicuously evident under the prevalent economic setup. As such, the present paper provided a description of the concepts pertaining to IFS that will help the readers to comprehend its fundamentals and, thereby, make way for its practical implementation. However, a detailed explanation of all the dynamics of IFS was not possible because that would have rendered the paper too lengthy for general audience.

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