

A Brief Note on the Islamic Financial System

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Introductory Note

The basic function of any economy is to allocate scarce and natural material resources in order to produce goods and services needed by society upon which the standard of living of the people depends. With the resources available at hand, it is not just possible to satisfy the unlimited demand of the people for goods and services until there is continuous and harmonious development of all the sectors of the economy which largely depend on the proper functioning of a just financial system or discipline. Human beings have both material and moral needs, and their desire for true peace and happiness depends on a balanced satisfaction of both of these needs. Provision of a just financial system and economic discipline might help achieve the various socio-economic goals of the economy for satisfaction of human needs and desire to a greater extent.

But the present world is experiencing innumerable economic maladies including poverty, unemployment, inequitable distribution of income, paucity of funds, social and economic injustice, absence of social security, instability in the real value of money, inflation, economic disequilibrium, accumulation of wealth in a few hands, concentration of economic power and the like, all of which greatly disturb achievement of peace and true happiness of mankind. Further, efficient management of finances, smooth formation of capital, continuous flow of investment, proper maintenance of stability in the real value of money, etc. have become unsettled and unstable to a great extent mainly due to prevailing conventional financial system which is based on and working mainly with *Riba* or interest principle. These economic ills are also seen widely prevalent and present in all the Muslim countries. Absence of a just financial system upon which the harmonious development of an economy largely depends might be one of the leading contributing factors for these stated dismal economic illnesses and conditions all over the world including the Muslim *Ummah*, the world nation of Islam.

With the passage of time, new instrument, techniques and institutions have developed to utilize and manage finances and capital. Such instruments, techniques and institutions developed for the purpose constitute the financial system, the primary function of which is to move scarce loanable funds from those who save to those who borrow for consumption and investment. By making funds available for lending and borrowing, the financial system provides the means, whereby modern economic systems develop and help maintain the standard of living of the people by satisfying the needs for goods and services.

The financial system performs a vital function within the economic system by channeling savings coming from households to individuals and institutions needing more funds for spending and investment. The ease of transferability not only ensures liquidity for holders of financial assets, thereby reducing the volume of idle balances in the economy, but also enables the optimum use of savings for long term productive activity (Chapra, 1991). Therefore, an efficient operation of the financial system tantamounts to the use by one party of the liquidity held by another.

Further, the financial system plays an important role in the overall economic development by facing and solving a lot of economic maladies and problems of a country. It shapes

the total economic system, acts as an intermediary between savers and investors and determines the quantum of speed for growth and development of a society. Besides its normal functions, it has to handle huge volumes of government debts, meet deregulations of the financial sector with accompanying increases in uncertainty and risk, handle the failures among financial institutions and industries, face the gradual erosion of public confidence in the viability and stability of important financial institutions, meet the increasingly tense competition for financial services in an international arena, etc. (Rose, 1986) A developed and efficient financial system is indispensable for an expanding economy, economic growth and prosperity. Thus, provision of a just financial system and economic discipline might guarantee true happiness of human beings of eradicating the economic maladies and illnesses from the society.

With the background developed above as a frame of reference as regards emergence, importance and functioning of a just financial system as an approach to human welfare, various issues related to the main topic like conceptual, ideological and functional differences between the prevailing interest-based conventional financial system and equity-based Islamic financial system, emergence of an independent Islamic financial system, mechanisms of product development and implementation of Islamic financial system, economic impacts of Islamic financial system, institutions needed for Islamization of ongoing financial system in Muslim countries, etc. need to be discussed and analysed in general context. The present study is an attempt to study the Islamic approach in these areas.

Objective

This brief note will point out salient features of the Islamic Financial System in the following areas: we will undertake a comparative view of the Islamic financial system vis-a-vis a conventional one. We will point out the principal Islamic financial instruments and look at their economic efficiency.

Role of Financial System in an Economy

A financial system whether Islamic or conventional generally consists of the Central Bank, Commercial Banks, Development Banks and Non-bank Financial Institutions. It also includes Insurance, Security Market, Stock Exchange, Investment Institutions, Government Bonds and Securities, Government Fiscal Policy, etc. In a word, a financial system comprises both the money market as well as capital market. It contains at least two types of capital markets, namely the Stock Exchange and the Commodity Exchange. The money market deals with short-term debt instruments and its function is to help bridge economic units temporarily to minimize the gap between their cash receipts and payments i.e. providing liquidity. While on the other hand, the goal of capital market is to channel the savings into long-term productive investments and it comprises the long-term debt instruments and equity obligations. In other words, financial markets are the heart of the financial system. They determine the volume of money and credits available, attract and mobilize savings, provide short-term and long-term financing, create investment opportunities, allocate resources, help produce essential goods and services etc. However, the role played by any financial system is immense and can be systematically delineated in the following section:

- (i) The saving function provides a potentially profitable and relatively low-risk outlet for the savings of the people;

- (ii) liquidity aspect provides a means of raising funds by converting securities and financial assets in the form of cash;
- (iii) payment technique provides mechanism for making payments for purchase of goods and services to meet the needs;
- (iv) policy determination provides a channel for Government Policy to achieve the goals of high employment, low inflation, economic growth and stability;
- (v) wealth creation-provides means to preserve purchasing power until the resource is needed at a future date for spending on goods and services;
- (vi) credit supply provides a continuing supply of credits for business, customers and government to support both consumption and investment;
- (vii) risk avoidance provides means to protect business, consumers and government against risks to people, property and income;
- (viii) investment opportunities provides opportunities for investment of surplus funds in various profitable as well as risk-controlled sectors of the economy for equitable mobilisation of economic resources and production of essential commodities to maintain a just living standard of the people of the society, etc. (Rose, 1986).

From the roles desired to be performed by any financial system of an economy, it is seen that the ultimate objective of a financial system is to strengthen the financial institutions in the development process of a country as a means of boosting the economic growth and stability, maintaining social and economic welfare, ensuring equitable distribution of income and wealth and alleviating poverty. The success and failure of the system will have a positive or a negative, favorable or unfavorable impacts on the overall economic condition of the country. Since mobilization of financial resources is the primary concern of the financial system, its failure might have adverse effects on savings and liquidity with the collapse of the payment function and other functions, leading to gross loss to the depositors, investors and government and finally total indiscipline and weakness in the economic arena.

Nature and Objectives of the Islamic Financial System

The Islamic Financial System, which is the specific area of the present study, is ideologically characterized by the absence of interest-based financial institutions/transactions, doubtful transactions, stocks of companies dealing in unlawful activities, unethical or immoral transactions such as market manipulations, insider trading, short-selling, etc.

The objectives of the Islamic financial system are based on Islamic Law, *Shariah*, which is to be treated as an important vehicle to transfer funds from the surplus to the deficit units. This is done to ensure the equitable allocation of capital to sectors which would yield the best returns to the owners of capital, thereby contributing towards the overall growth and expansion of an economy.

Another important objective of the Islamic financial system is to ensure that the surplus fund be attracted for worthwhile investments in accordance with the owners' preference in terms of the extent of risk involvement, rate of return, as well as the period of investment. Still another objective of the Islamic financial system is to help the fund owners

to find sufficient opportunities to invest for the short term. Since it is contrary to *Shariah* principles to hoard wealth, it is necessary for the wealth owners to invest their funds in projects of either short-term or long-term nature.

The Islamic financial system is viewed by Muslims as an alternative to the existing interest-based financial system and institutions and by non-Muslims as a healthy development that adds a variety rendering financial system as highly competitive (Khan, 1992).

Islamic versus Conventional Financial Systems

In this section we shall briefly explain the basic differences between the conventional financial system (CFS) and Islamic financial system (IFS). In fact, the differences between the two systems emerge from philosophical and ethical viewpoints. The conventional financial system is secular in philosophy and principle generating financial capitalism. The CFS recognises the individual as the exclusive owner of his property with absolute rights to wealth.

The Islamic financial system is a product of Islamic principles and philosophy and is based on *Shariah* functions. Since this system is an important part and parcel of Islam, IFS recognises man as the vicegerent of God on earth. Any wealth earned by a man is seen to be merely entrusted upon him. He holds the wealth as a trust from God, and does not have absolute ownership of the wealth. As such, in an IFS, freedom of enterprise as well as financial decisions made either by individuals or corporations, should be on the basis of guidelines given by Islam. These do not prohibit profit making as the target, as long as the interest of society and the nation as a whole are protected and preserved; the profitable undertaking is permissible under *Shariah*.

The CFS is based purely on *Riba* (interest). Whereas interest is strictly prohibited in Islam. Yet IFS is purely based on reward/loss/compensation and charity instead of *Riba*. It is increasingly found that the financial system based on *Riba* results in concentration of income and economic power in few hands, while the financial system based on profit and loss sharing principle will result in more equitable distribution of economic opportunities and productive social change in the long-run.

As regards financing too, there are differences between the conventional system and the Islamic system. There are two types of financing which are necessary in both the financial systems. In the contemporary conventional system, equity financing takes place throughout the issuance of shares on which dividends are earned while debt financing takes place by way of loans and borrowings on which interests are given or taken. The Islamic financial system has its own unique norms and regulations as regards both equity and debt financing. In equity financing, Islamic system is based on profit sharing contracts. Two important contracts in this category are used viz. *Mudarabah* and *Musharakah*. *Mudarabah* in this respect refers to the issue of shares without having the right of management or voting rights in the project concerned. *Musharakah* refers to the issue of shares with management or voting right.

In the case of debt financing, Islam permits the contract of exchange which involves deferred payments and there are three important contracts in this category viz., firstly, *Bai Muajjal* or sale on deferred payment, under which an entrepreneur of a project can buy the required goods and pay in instalments later on. Secondly, *Ijarah* or leasing under which the entrepreneur can lease the goods required for his project. Thirdly, *Murabahah* or sale with

price mark-up is commonly used in trade financing wherein the entrepreneur can purchase raw materials but settle the payments in cash at a later date. All these three types of contract provide profit margin to the financier through the cost plus pricing of sale and rental on leasing as agreed upon.

Principal Islamic Financial Instruments

With the elimination of *Riba* or interest, appropriate mechanisms should be developed to make feasible the workings of the Islamic financial system. The role of an Islamic financial system is to mobilize savings on a large scale, pooling money from the savers to be mobilised to the investors for different periods and with different risk levels through various products mechanisms that conform with *Shariah*. Some of the Islamic financial products whose conformity with *Shariah* has been established are as follows:

(1) Generation of Deposit on Profit and Loss Sharing

All deposits generated on profit and loss sharing basis should be invested in non-interest based instruments while profit earned and loss incurred should be shared between the involving parties. For this purpose, the interest-based income should be separated from non-interest based income (if any) and the basis of sharing of profit and loss between the parties should be predetermined. Different modules have been developed for the distribution of profits.

(2) *Mudarabah*

Mudarabah is defined as a business in which a person participates with his money and another with his efforts. Their proportionate shares in profit are determined by mutual agreement. The loss, if any, is borne by the owner of money only.

(3) Unit Trusts

Unlike *Mudarabah* certificates, which cannot be repurchased by the company issuing those certificates, the Unit Trust Certificates can be sold and repurchased by the company issuing them. This product can be used by the Islamic Banks and financial institutions both for generation of deposits and investment of bank funds.

(4) Participation Term Certificates

A participation term certificate (PTC) is a method whereby fund can be generated for a specified period on profit and loss sharing basis. An Islamic Bank may issue registered fixed denominations for a fixed period on the basis of payment of a share of the bank's profits to the PTC holders. A provisional rate of profit may be applied subject to a final determination at the time of declaration of annual profits by the bank.

(5) Modes of Financing

The modes of financing as permissible under Islamic financing system are

- (a) Loans on a service charge which is the percentage of annual administrative expenditure to the average annual assets of the banks;

- (b) Loans without a service charge (*Quarz-Hasana*), i.e. some portion of Islamic bank's fund can be used for realizing such social assistance as making interest-free loans to deserving persons from education, medical treatment or other noble objectives;
- (c) *Bai-e-Muajjal* or *Murabaha* is financing to purchase goods by banks and their sale to clients at mark-up prices on deferred payment basis;
- (d) Leasing and hire purchase (*Ijara*) is a contract allowing use of land, building, equipment or other fixed assets for a specified period in exchange for payment in the form of rent;
- (e) *Musharakah* is a partnership between the bank and its clients under which bank provides capital finance as per terms agreed, with profits and losses shared in agreed ratios;
- (f) Rent Sharing is practised in real-estate and equipment rental.

Financial Institutions for Development of Islamic Financial System

In order to regulate and streamline the financial system towards achieving the goals of Islamic financial system, appropriate financial institutions need to be developed. Because financial institutions are the agents through which the goals of the Islamic financial system would be realised and as such, it is imperative to deal with the reorganization of conventional money and capital market institutions to enable them to serve the socio-economic objectives of the Islamic system.

The main objective of an efficient financial system is to bring together savers and investors. This can be done in two ways: firstly, the traditional intermediation process can be adopted. Here the financial institutions make loans and investments with the funds generated through deposits and other sources of funding and financial institutions undertake investment decisions and bear risk. Secondly, the securities markets wherein the financial institutions sell investment instruments directly to investors and pass the risk to the buyers can be mobilised. Both of these ways are possible within the Islamic system. The most important techniques of financial available within the framework of the *Shariah* are: *Mudrabah*, *Musharakah* and the acquisition of shares for establishment of joint stock companies.

In the case of *Mudrabah*, the financial institutions instead of participating in the management of the business finance, need to exercise adequate supervision to ensure that the funds are used properly. A part of the total financing agreed between the financial institutions and the share holders may be allayed while the remaining part may be made available for short periods to offset the shareholders funds in transit or to take care of liquidity shortages. In the case of *Musharakah*, the financial institutions and the entrepreneurs can pool their talents and expertise for the management of their business.

Investment in the stocks and shares of well-established and high-dividend yielding companies should be an attractive area for employment of bank funds instead of setting them in interest-bearing government securities and bond's issues.

There are other Islamic financing modes as well, such as *Ijarah* (leasing), *Ijarah wa-Iqtina* or *Ajar* (hire-purchase), *Bai-al-Muajjal* or *Bai-Murabaha* (contract sale for profit) and *Bai al-Salam* (forward sale or advance purchase).

Fundamental change in the nature and objectives of intermediation will naturally demand a significant transformation in the nature and responsibilities of financial institutions in an Islamic financial system. Institutions whose reform will be needed include the Central Bank as well as of Money and Capital Market intermediaries - the commercial banks, the auxiliary institutions and the stock market (Chapra, 1991).

Conclusion

There has been a rapid emergence and development of Islamic Banks in the last quarter of the present century. Presently there are over 200 Islamic banks and financial institutions in Asia, Europe and Africa. The total financial resources of these banks and institutions together hold up to 1.7 billion dollars and an annual rate of increase of 15 to 20 per cent in deposits. Islamic banks and financial institutions being the foundation of an emerging Islamic financial system have now become a reality. It is hoped that if these banks and institutions succeed in establishing their viability and demonstrate an example of socio-economic transformation, there would be more likely co-operation between them and the western world on the basis of Islamic financial principles.

References

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