

follow. If one country does not want to play the game then the whole game will collapse. Large amount of short term capital flight into a country created artificial prosperity which again caused excessive borrowings by both government and private sectors. These excess liquidity went to the property and share markets and inflated the economy cause over capacity and over investment. What worse still is that some of these investments were financed by the banks while the collateral are over valued share and property. Once the venerability of the economy is prevailed then the game can not continue any more. The games like a group of indebted people borrowing from one side and pay to other side. If one party decides to quit from the game than the whole system is in trouble.

Chapter 2

THE ISLAMIC FINANCIAL SYSTEM

2.1. The Islamic Financial System-Definition

Islamic financial system is the financial system which based on the principle teaching of the Quran and the tradition of the prophet Muhammad. It is the integral part of the Islamic economic system which set it's goal to improve and human economic life, eliminate economic injustice, and facilitate human to efficiently utilize their God-giving factors of production to achieve their ultimate aim as the vicegerent of Allah on the earth. Such financial system should be applicable in all sorts of societies and economies. Since the Quran only gives the principle rather than the details there is wide room for the economist and

financier to apply their talent to build and adjust such system to suit in the interest of a particular economy.

An Islamic financial system is a system which is free from the unfair dealings such as taking and giving Riba', wastage, hoarding of the essential items, and illegal undertakings. Islamic financial system is promoting efficient utilization of the capital in the real production sector therefore, most of its financial instruments are equity based and trade based, while debt financing is allowed it is however limited in the minimum level. Loan is only allowed when it is interest free or Al-Qaradha Al-Hasanah. Since if giving credit is the main source of income then there will be an unfair dealings; those who have will consistently gain because they have nothing to loss whether the loanable fund has generated profit or not. The return is fixed commitment, while the loan takers will expose themselves in the nuked capital market under the cut throat competitions. Moreover, since collateral is an essential requirement in applying any loan, the poor who has nothing to pledge will be denied from the participation in the economy though they might have very good entrepreneurs skill.

Islam prohibits buying and selling any claims on title which one yet to own fully. Hence the modern form of margin finance is prohibited. The reason is quite obvious for us now after we experienced the current financial fiasco, people financed their trading capital by the loans obtained from the bank; while the collateral they put are superficially over-valued. The shares these people bought are financed by margin, that is they might pay only a small portion of the total cost. Because using of leverage the margin transactions are very volatile. Once the venerability reveals, people pulling away their funds from the market, the value of the shares are dropped drastically. The collateral are no more worth than they supposed to be, margin calls are issued and this force people to borrow more to pay the banks, the banks bad debts or non-performing loans as a result are piling up threatening the collapse of banks . Would the Islamic financial rules are imposed should not

there any crisis at least not as serious as now since Islamic bank has better loan recovery records than the conventional banks(Abdus Samad 1999)⁶.

Islam also requires transaction of goods or services which can be delivered in a reasonably certain manner; and the purpose of the transaction should be clear. Any open ended contract is deemed illegal. Since the financial index can not be delivered therefore trading on the financial index is prohibited.

The purpose of these prohibition and encouragement is to achieve the justice in the economic and business dealings. Due to the asymmetric of the information some people might take advantage out of others unknown. While fair competition is encouraged, cheating and manipulation are strictly prohibited.

Islamic financial system is cash based therefore it has very high integrity, the risk is much smaller in such system, because there is no "systematic risk" in the sense there is no syntactic or artificially created wealth. Though the trading volume might be smaller but the economies as a whole will not loss any thing.

Furthermore, the participative financial and instruments used in the Islamic financial market will create a sharing attitude where the risk and the profit are shared by both the capital providers and the capital users. Hence the chance to utilize the capital and the talent of the project manager in the production manner will be more. This will create a situation where more people will become relatively richer rather than few people became very rich. As we know very well it is the vast mid-income group which cause the economy to grow not the few high income groups.

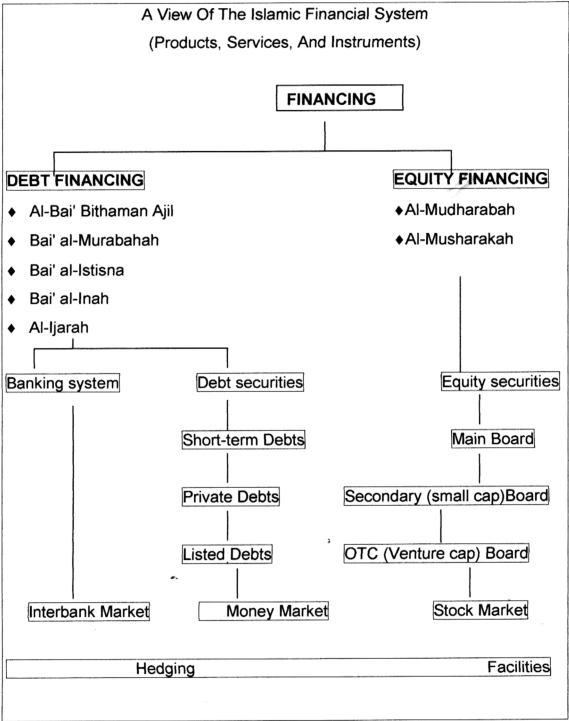
In the theory the Islamic financial system will be more transparent has better governance(both internal governance through building up the trust or Amanah

and external governance through market supervision), it will be more economically beneficial and socially desirable.

Islamic financial system is not a mere "interest free financial system" The philosophical foundation of an Islamic financial system goes beyond the interaction of factors of production and economic behavior. Whereas the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work ethic, wealth distribution, social and economic justice, and the role of the state. The Islamic financial system is founded on the absolute prohibition of the payment or receipt of any predetermined, guaranteed rate of return. This closes the door to the concept of interest and precludes the use of debt-based instruments.^c The system encourages risk-sharing, promotes entrepreneurship, discourages speculative behavior, and emphasizes the sanctity of contracts. Figure 2.1 can give some diagrammatic understanding on Islamic financial system.

^cMalaysia has legalized debt financing in certain extend.

Figure 2.1 A View Of Islamic Financial System



2.2. Principles Of An Islamic Financial System

The Islamic financial system draws its framework from Islamic law of Shariah which is governing economic, social, political, and cultural aspects of Islamic societies. The basic principles of an Islamic financial system are as follows:

Prohibition of interest. Prohibition of *Riba*, a term literally meaning "an excess" and interpreted as "any unjustifiable increase of capital whether in loans or sales" is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment) is considered *Riba* and is prohibited. The general consensus among Islamic scholars is that *Riba* covers not only usury but also the charging of "interest" as widely practiced. (Zakriya 1996)⁷

This prohibition is based on arguments of social justice, equality, and property rights. The Quran encourages the earning of profits but forbids the charging of interest. This is because profits, determined ex post, symbolize successful entrepreneurship and creation of additional wealth whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

Risk sharing. Because interest is prohibited, suppliers of funds become investors instead of creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits. Such cooperation can embody the spirit of Islamic Brotherhood and guarantee nobody is being neglected from enjoying the bounty of God.

Money as "potential" capital. Money is treated as "potential" capital--that is, it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is "potential" capital. No such thing as "money makes money" in Islamic finance.

Prohibition of speculative behavior. An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, such as gambling, financial derivatives etc.

Sanctity of contracts. Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. This is why Prophet Muhammad prohibit traders to buy the farmers' goods before they reach the market, because those farmers might not know what is the actual market price.

Shariah-approved activities. Only those business activities that do not violate the rules of *Shariah* qualify for investment. For example, any investment in businesses dealing with alcohol, gambling, and casinos would be prohibited.

An Islamic financial system can be expected to be stable owing to the elimination of debt-financing and enhanced allocation efficiency. An Islamic financial intermediaries should have 100% reserve for its demand deposits, and investment deposits are accepted purely on an equity-sharing basis. Such a system will be stable since the term and structure of the liabilities and the assets are symmetrically matched through profit-sharing arrangements, no fixed interest cost accrues, and refinancing through debt is not possible. Allocation efficiency occurs because investment alternatives are strictly selected based on their productivity and the expected rate of return. Finally, entrepreneurship is encouraged as entrepreneurs compete to become the agents for the suppliers of financial capital who, in turn, will closely scrutinize projects and management teams.

2.3 Market Trends

Banking is the most developed part of the Islamic financial system; Therefore, sometimes people even use Islamic banking system and Islamic financial system interchangeably. The state constitutions of Iran and Pakistan, for example, require their banking systems to be fully compatible with Islamic law (Wilson 1996).⁸ In Egypt, Indonesia, Malaysia, Sudan, and the Gulf Cooperation Council (GCC) countries, Islamic banking exists alongside conventional banking. Islamic banking is currently practiced in two ways one is through full fledged Islamic Banks and another is offering Islamic banking services in conventional banks. Most of big banks in the world now offer Islamic banking services^d.

Islamic banks used to be small and offer limited services, but now many of them becoming resourceful and are going global, in part owing to their increased integration with international markets. At the same time, aware of the potential of Islamic markets, Western banks are reaching out to investors directly and eliminating the middleman--the Islamic banks or Islamic windows of banks in Muslim countries. For example, Citibank opened its first Islamic bank subsidiary in Bahrain in 1996.

Historically, Islamic financial markets have lacked liquidity-enhancing instruments, thus eliminating a large segment of potential investors. However, more liquid instruments are emerging through securitization; Islamic funds, with a current market size of \$1 billion, represent the initial application of securitization (see table). There are three types of Islamic funds: equity, commodity, and leasing^b. Equity funds, the largest share of the Islamic funds market, are the same as conventional mutual funds but with an Islamic touch that requires a unique filtering process to select appropriate shares. The

^d HSBC Bank has special Amanah financial unit for Islamic Banking services, Bank of America and standard Chartered banks have Islamic Banking units, Citibank offer Islamic finance and corporate banking

filtration process ensures that the mode, operation, and capital structure of each business the fund invests in are compatible with Islamic law, eliminating companies engaged in prohibited activities and those whose capital structure relies heavily on debt financing (to avoid dealing with interest). For this reason, companies with a negligible level of debt financing (10 percent or less) may be selected, provided that the debt does not remain a permanent feature of the capital structure. Malaysia's Securities Commission also regularly publishes the list of the Halal (lawful by Islamic standards) shares that can be invested by Islamic fund.

The future of Islamic equity funds is bright in part because of a new wave of privatization under way in Muslim countries such as Egypt and Jordan, and in high-growth Islamic countries such as Indonesia and Malaysia, where the demand for Islamic financial products is growing rapidly. Commodity and leasing funds are other forms of Islamic funds. Commodity funds invest in base metals. Leasing funds pool auto, equipment, and aircraft leases and issue tradable certificates backed by the leases.

^b For some countries, like Malaysia, Islamic debt also can be one type of fund

Table 2.1. Emerging Islamic Funds

| Fund | Type | Year launched | Financial institution | Size (million dollars) |
|---|---|---------------|---|------------------------|
| IIBU Fund II Plc | Leasing | 1994 | United Bank of Kuwait | 51.5 |
| Faysal Saudi Real Estate Fund | | 1995 | Faysal Islamic Bank of Bahrain | 27.0 |
| GCC Trading Fund | | 1996 | Faysal Islamic Bank of Bahrain | 10.0 |
| Oasis International Equity Fund | Equity | 1996 | Robert Fleming & Co. (United Kingdom) | 16.6 |
| Faisal Finance Real Estate Income Fund II | Real estate | 1996 | Faisal Finance (Switzerland) S.A. | 100.0 |
| Unit Investment Fund (all tranches) | Income/ <i>mudarabah</i> syndication | 1996 | Islamic Development Bank (Saudi Arabia) | 500.0 |
| Al Safwa International Equity Fund | Equity unit trust | 1996 | Al-Tawfeed Company for Investment Funds Ltd.. | 27.0 |
| Ibn Khaldun International Equity Fund | Equity | 1996 | PFM Group (United Kingdom) | 25.0 |
| Adil Islamic Growth Fund | Equity | 1996 | Faisal Finance (Switzerland) S.A. | 10.0 |

Source: *Islamic Banker*, 1995& 1996, various issues.

International and regional institutions are working with Islamic finance and are contemplating the introduction of derivative products and Futures products to enhance project finance. The introduction of derivative and futures products is

very controversial and need cautiously study, it is suspected that these incorporate interest and may also support speculative activities. Simple derivatives, such as forward contracts, are being examined because their basic elements are similar to those of the Islamic instrument of deferred sale. Project finance, which puts emphasis on equity participation, is another natural fit for Islamic finance. The successful experimentation with long-term project financing in the construction industry in Malaysia is a positive development in this area.

2.4. Issues And Challenges

Islamic financial markets are operating far below their potential because Islamic banking by itself cannot take root in the absence of the other necessary components of an Islamic financial system. A number of limitations will have to be addressed before any long-term strategy can be formulated:

- A uniform regulatory and legal framework supportive of an Islamic financial system has not yet been developed. Existing banking regulations in Islamic countries are based on the Western banking model. Similarly, Islamic financial institutions face difficulties operating in non-Islamic countries owing to the absence of a regulatory body that operates in accordance with Islamic principles. The development of a regulatory and supervisory framework that would address the issues specific to Islamic institutions would further enhance the integration of Islamic markets and international financial markets.
- There is no single, sizable, and organized financial center that can claim to be functioning in accordance with Islamic principles. Although stock markets in emerging Islamic countries such as Egypt, Jordan, and Pakistan are active, they are not fully compatible with Islamic principles. The stock markets in Iran and Sudan may come closest to operating in compliance with Islamic principles. Moreover, the secondary market for Islamic products is extremely shallow and illiquid, and except Malaysia,

money markets are almost nonexistent in other Muslim countries, since viable instruments are not currently available. The development of an interbank market is another challenge.

- The pace of innovation is slow. For years, the market has offered the same traditional instruments geared toward short- and medium-term maturities, but it has not yet come up with the necessary instruments to handle maturities at the extremes. There is a need for risk-management tools to equip clients with instruments to hedge against the high volatility in currency and commodities markets. In addition, the market lacks the necessary instruments to provide viable alternatives for public debt financing.
- An Islamic financial system needs sound accounting procedures and standards. Western accounting procedures are not adequate because of the different nature and treatment of financial instruments. Well-defined procedures and standards are crucial for information disclosure, building investors' confidence, and monitoring and surveillance. Proper standards will also help the integration of Islamic financial markets with international markets.

Islamic institutions have a shortage of trained personnel who can analyze and manage portfolios, and develop innovative products according to Islamic financial principles. As a result the average fund utilization rate, the profitability, the managerial efficiency all are poor in the Islamic bank compared to that of the conventional banks(Samad1999).⁹ Only a limited number of Islamic institutions can afford to train their staffs and deploy resources in product development.

- There is lack of uniformity in the religious principles applied in Islamic countries. In the absence of a universally accepted central religious authority, Islamic banks have formed their own religious boards for guidance. Islamic banks have to consult their respective religious boards,

or *Shariah* advisors, to seek approval for each new instrument. Differences in interpretation of Islamic principles by different schools of thought may mean that identical financial instruments, for example the debt instruments, are rejected by one board but accepted by another. Thus, the same instrument may not be acceptable in all countries. This problem can be addressed by forming a uniform council representing different schools of thought to define cohesive rules and to expedite the process of introducing new products.

2.5. *Future directions*

The further growth and development of the Islamic financial system will depend largely on the nature of innovations introduced in the market. The immediate need is to deploy human and financial resources to develop instruments to enhance liquidity; develop secondary, money, and interbank markets; perform asset/liability and risk management; and introduce public finance instruments. The Islamic financial system can also offer alternatives at the microfinance level.

Securitization is a step in the right direction but even this requires more sophistication. The scope of securitization, the process of unbundling and repackaging a financial asset to enhance its marketability, negotiability, and liquidity, in Islamic financial markets is very promising. Because current market operations are restricted by the dearth of liquidity-enhancing products; secondary markets lack depth and breadth; and, more important, instruments for asset/liability management are simply nonexistent. With the expansion of securitization, the customer base of Islamic financial systems will grow as institutional investors, who have access to broader maturity structures, are attracted to the market; the secondary market will develop; and asset/liability management will become a reality. Other strong candidates for securitization include real estate, leasing, and trade receivables because of the collateralized nature of their cash flows.

Microfinance is another candidate for the application of Islamic finance. Islamic finance promotes entrepreneurship and risk sharing, and its expansion to the poor could be an effective development tool. The social benefits are obvious, since the poor currently are often exploited by lenders charging usurious rates.

An Islamic financial system can play a vital role in the economic development of Islamic countries by mobilizing dormant savings that are being intentionally kept out of interest-based financial channels and by facilitating the development of capital markets. At the same time, the development of such systems would enable savers and borrowers to choose financial instruments compatible with their business needs, social values, and religious beliefs(Iqbal, 2000).¹⁰

Although the prospect of Islamic financial system is bright, however the credit based financial system is so deeply rooted in the mind of the modern people that until the Asian financial crisis a few people has questioned about its legitimacy. The infancy stage and anti-conventional nature of Islamic financial system has made people very timid about using it in big scale. However, the comprehensive test of the Asian financial turmoil has caused governments and people start to suspicious about the current system. Their start to rethink about the reformation of IMF, World Bank, etc. the Islamic financial system is also being looked as an alternative to solve the problem not only by the Muslims but also by the non-Muslims. Since then there have been applications of Islamic financial products in the different social economic environments and has proven successful. Before going into the details some brief looking of the Islamic financial instrument is essential.