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Islamic Financial System: A Brief Introduction from the Literature

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Abstract

Islamic financial system has achieved a large-scale growth and arriving at a new level of experience in the Muslim countries and around the globe. It helps to provide a basic foundation to establish complex tools that will promote to identify of the best risk management instruments and liquidity of resources. Shariah is the derivation of individual, family and societal norms through the study of revered book Quran and the sayings of the Prophet called Sunnah. Islamic financial system is influenced by many factors like structural reforms and global integration of financial markets. The system is facing many challenges that need to be addressed and resolved relating to Islamic financial markets, financial products, regulatory laws, and bringing awareness in the personal and business world. In this review studies, we have tried to summarize based on existing literature and particularly, elaborate the characteristics, modes, and philosophies of Islamic finance and the banking system. Furthermore, this study also presents a pragmatic judgment of the conduct of the Islamic financial market in the financial world market.

Keywords: *Islamic finance, Islamic banking, conventional banking, Sharia regulatory board, Islamic capital market, Sukuk.*

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1- Introduction

Islamic finance has emerged as an effective financial instrument and gain popularity over the past decades in the Muslim and non-Muslim world [1]. It has achieved 10-12% annual growth in recent years. Islamic financial organizations working in more than 60 sovereign states having aggregate sharia compliance resources of US$ 2.2 trillion, representing less than 1 percent of the universal financial market [2]. Islamic financial system has grown at a higher rate but due to identifiable products, the market is still at the premature phase of development [3]. Furthermore, in most of the Muslim world, the growth level of Islamic financial assets is fastened than the traditional system [4]. Islamic finance is a financial structure that follows Islamic decree called Sharia. Shariah is the Islamic legal system based on personal, family and general norms derived from the study of the Holy Quran and the sayings of the prophet called Sunnah [5]. Islamic financial system provides a base for ethical investment and bound the organizations to be socially responsible towards the society [6-9].

Like other cultural values, the Islamic financial system reflects Islamic values in the economic dealings. The organizations work under the Sharia umbrella and has to follow Islamic law and financial industry rules and regulations. It will provide a basic foundation to construct complex tools and help to establish risk management tools and enhance the liquidity of assets [10]. The Islamic financial system not only strengthens the core industry but bringing continuous advancement and innovations in the products and services to maintain and attract potential customers. After the end of the colonial era, Muslims started to regain their lost identities and all values especially in the economic range [11]. Islamic financial structure includes Islamic banks, Sukuk contracts, Islamic funds, takaful, and supplementary Islamic financial bodies, etc. The Stakeholders are assumed to ration the gains and losses from the venture while avoiding charging interest.

The Islamic financial system is developing day by day due to the growing demand for interest-free products [12]. The more banks are taking keen interest to expand its branching network by opening Islamic branches. This is not only the case of Islamic banks to grow their business, but the conventional banks are trying to take advantage by differentiating their conventional banking network by adding some words to their bank's name.

1.1- Philosophies of the Islamic financial system

a) Prohibition of Interest (Riba):

Riba is providing or receiving money/capital at a fixed percentage of interest [13]. There is no place for interest to be used in the Islamic financial system due to its strict prohibition in Islamic law [14]. All individuals, banking sector and other financial institutions can do business by providing financial products that don’t bear interest

(Riba). Interest-based loans exploit the poor and increase poverty, the fixed rate of interest should be paid even in case of crises or losses which become a burden on small scale businesses as the individual hesitate to finance their ventures, thus riba has a socially and economically negative effect on the economies.

b) Customers:

The Islamic financial system is not merely restricted to the Muslim world but has got popularity in some non-Muslim countries. Before the financial crises of 2008, Islamic finance was popular in most of the Muslim world but after the crises, the world recognizes Islamic banks, which represents itself as a reliable alternative to the traditional financial system [15, 16]. Now the non-Muslims states are also taking a keen interest in Islamic financial derivatives and enjoying the benefits. It links the financial sector to the real economy and has been considered an equity-based, asset-backed, and ethical investment which promotes risk-sharing.

c) Poverty Alleviation:

The Islamic financial system has the future to address the challenges facing society to alleviate the utmost poverty and enhance common prosperity through access to finance, establish a financial sector and stability [4]. The concept of Islamic microfinance has been developed to help the poor as an alternative remedy to alleviate global poverty [17].

d) Halal Businesses Activities:

The parties concerned will not be engaged in businesses that are prohibited by Shariah. Like smuggling, wine business, pork breeding, gambling, night clubs, tobacco, pornography, casino games [6, 18-22]. These ventures will follow Islamic law in true spirit to promote an environment of shared prosperity.

e) Speculation/Gambling (Maisir):

Gambling is an acquisition of getting money/wealth by chance [23]. The practice of speculation and gambling are strictly prohibited as there are no real assets exist and ownership of asset depends on the occurrence of an uncertain happening in the future which makes the contract null and void as per Islamic law.

f) **Uncertainty (Gharar):**

The Islamic financial system helps to reduce uncertainty due to linkage with the real economy [24]. In Islam speculation is prohibited as it comprises high uncertainty and is a form of gambling where minority investor gets what the majority lose [3, 25-27].

g) Risk Sharing:

The profit or loss from the economic activities in the future will be shared by the supplier and user of resources at the agreed ratio but the total amount will not be fixed. It depends on the agreement of the parties concerned that how much percentage or ratio they will get in future profit.

h) Assets Link to the Real Economy:

Some key attributes of Islamic agreements are risk-sharing, direct asset linkage with the real wealth and ignore toxic instruments and other financial products [28]. The contract of Islamic financial instruments is also dissimilar from other conventional instruments in terms of structure and linkage to the real assets [29, 30].

1.2- Is the Islamic Financial System Proved Itself in Financial Crises?

The answer is "yes". It had proved himself in times of crisis when people lack trust in the financial system. Many empirical lessons exhibited that Islamic banks as compared to other traditional banks were better performed, more profitable due to risk activities, higher resilient, and financially stable in global financial crises [31-39]. After the financial crises of 2007-2008, the academicians, investors, and policymakers have taken keen interest to recognize the role played by Islamic finance in different sectors [40] and got the attention of research scholars across the globe. The sharia-compliant prohibits making money from money and speculated options and belief in real physical assets. That's the reason why Islamic financial resources resisted to the shocks of financial crises of 2008. The absorbing of financial shocks provides a stable and reliable picture to the world. The IMF, also concluded that "adherence to Shariah principles—which precluded Islamic banks from financing or investing in the kind of instruments that have adversely affected their conventional competitors—helped contain the impact of the crisis on Islamic banks"[41].

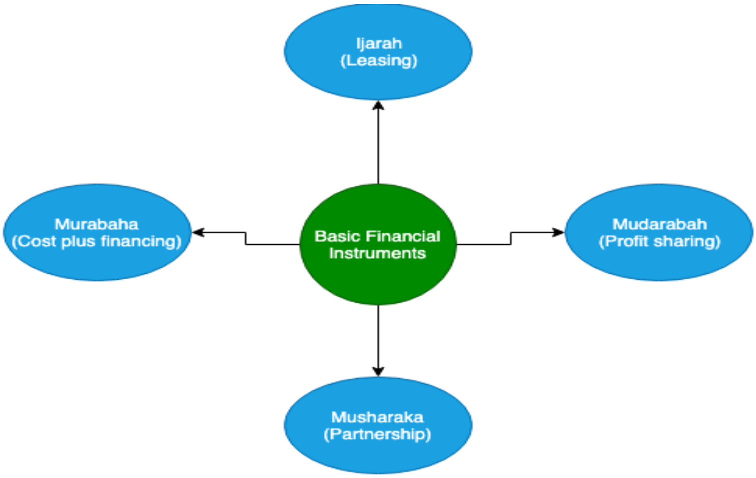
2- Role of Religious Scholars in the Supervisory Board of Islamic Banks and Other Islamic Financial Institutions.

A spiritual environment may encourage professional and personal behaviors and institutional restraints [42]. It includes the products and services following Shariah (Islamic teachings). Every Islamic financial institution has its own autonomous Shariah regulatory board included at least three religious experts. The members of the board have a command on specialized knowledge of up-to-date business, economics, and finance. For the best practices of corporate governance in Islamic financial organizations, there is a double check in the form of a religious supervisory board that has both supervisory and consultative functions. The job of the Shariah supervisory board is to give professional advice and regulatory authority to verify operations and certify products. Their decision is based on Islamic law i.e. the Holy Quran and sayings (Sunnah) of the Prophet Muhammad (PBUH) to differentiate what is halal (allows by Islamic law) and haram (forbidden by Islamic law). The board carries great responsibilities on their shoulders, and the financial institutions cannot adopt any business activity or financial product that is not approved by the advisory board. Their approval on the part of banking, financial offerings should be in line with Shariah law. The advisory Shariah board has to issue the certificate of Shariah compliance on the offerings presented by their respective Islamic financial organizations. Furthermore, it is very important to appoint the high caliber religious scholars on the advisory board. The management of Islamic banks bring their routine problems in front of the board and the advisory board will see the matter as per Shariah law [43].

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an organization with a motive not for income but to maintain and formulate the Shariah standard to be implemented by the Islamic financial system [44].

3- Modes of Islamic Financial System

The basic modes or forms of financial instruments used by the Islamic financial system are presented in the following figure.



Basic Modes of Islamic Financial System

i- Musharaka (Partnership): Musharaka is like an ordinary partnership business according to Islamic law. It is also called participatory models in which Islamic banks and clients engage as a partner to get some financial benefits as per Shariah [45, 46]. It is a type of joint venture where the participants will share the gains or losses of economic activities [46]. The fund providers and users can do a halal business and share the profit of the business at the agreed ratio/percentage. Most of the people are engaged in this sort of business.

ii- Mudarabah (joint venture): This mode of Islamic finance needs trust, integrity, devotion, and honesty to do business. The fund's provider is known as Zarib while the fund user called Mudarib. The profit of the business will be shared among both or all the participants at a predetermined agreed ratio while the loss will be tolerated by the fund's providers (Mudarib). In the situation of more than one fund provider, the loss will be shared according to their capital ratios of the fund's providers.

iii- Ijarah (Leasing): Ijarah is a flexible mode of finance. In this type of contract one party purchases a product like equipment, motor car, or any other vehicle and allows the others to use the asset in return of some rental installments until the termination of the contract 39. This takes the form of the leasing contract and the lessee is bound to pay rental payments as per the agreement and the possession of the asset will be reassigned when the whole amount is paid by the lessee to lesser 47.

iv- Murabaha (Cost-plus profit): Murabaha is derived from the Arabic word ribh, meaning "increase". In this contract, the goods purchased by the seller were offered to the purchaser at the cost of the goods by adding a reasonable profit. The cost of the goods purchased will be communicated to the purchaser [39]. The key benefit of Murabaha is the property belongs to you.

4- Difference Between Islamic and Conventional System

The products and services offered by the Islamic financial system and conventional financial system are not much dissimilar, but the offerings presented by the Islamic financial system are built on established moral and ethical doctrines. Islam recommends a unique economic culture system of how to organize an economy which is different in many aspects from those proposed by other schools of thought [11]. Islamic financial system is unique and different from other traditional financial systems in terms of nature, operations, and composition of assets and liabilities structure [24, 48]. It is also established on the principles of sharing gains and losses while the conventional system offered a fixed rate of return. The restriction of receiving and paying off interest while financing the individual or businesses is the core of the Islamic financial system.

5- Features of Islamic Financial System

5.1- Islamic Capital Markets Leading Industry Growth:

Islamic Sukuk (Islamic bonds) and Islamic funds are the important financial instruments of the capital market. These assets grew up by CAGR (Compound annual growth rate) of 6% to US$ 2.44 trillion from 2012-2017 while the fastest growth has been shown by Australia, Cyprus, and Nigeria. Furthermore, Malaysia is the leading Sukuk marketplace and is considered to be a principal Islamic financial market in terms of the overall development whereas Saudi Arabia issued Sukuk bonds of a value US$ 26 billion in 2017 showed an increasing competition in terms of Sukuk issuance [49].

5.2- Islamic Banking:

Islamic banking is getting importance not merely in Muslim republics but also in the non-Muslim world [50]. Islamic banking is the main contributor, 71% to the Islamic finance industry assets which includes commercial banks, investment houses, wholesale, and other financial institutions. In geographically areas like Pakistan, gulf and sub-Saharan Islamic banks faces direct competition with conventional banks to provide attractive offerings to their customers. Does the question arise, what brand the Islamic financial system special? There is no place for interest in economic dealings, the lenders and borrowers are restricted to charge and pay interest which makes it clear that Islamic banks don't issue interest-based loans [51].

5.2.1- Question Regarding How These Banks Make a Profit

As the financial organizations are not allowed to do interest-based dealings, the banks buy physical assets like electric equipment (refrigerators, air-conditioners, laptops, mobile phones) automobiles (cars, buses, and trucks) other real estates and resell on installments or lease to the other interested parties. Here the risk-sharing factors are arises which is absent in the traditional banking system. Empirically studies showed that both Islamic banking and traditional banking models are different from each other in terms of their operations and assets structure [52]. Islamic banks are comparatively less cost-efficient, higher credit quality, more involved in fee-based businesses/revenue and have a higher capitalization than traditional banks [24, 31, 52-59]. In contrast, some evidence showed Islamic banks are more cost-efficient than other banks, while findings showed in terms of overall efficiency there is no significant difference between Islamic and conventional banking system [60, 61].

5.3- Sukuk:

Sukuk contracts are the financial derivatives showing possession in equity, real economy assets, and any combination of these securities. The Sukuk holders have the right to take benefits and risks representing by these securities [38]. The Sukuk issued in the late 1990s had the same purpose as conventional bonds but it is viewed as a certificate of ownership in assets rather than a debt obligation [2]. The return on Sukuk is expected from real assets and in case of capital appreciation the return is more while on the other side, conventional bonds have a fixed rate of interest [39]. It is the second-biggest contributor to the Islamic financial assets industry which includes the corporate issuance 63 percent followed by sovereign Sukuk 31 percent and other agencies 6 percent. The Sukuk has been issued domestically and internationally. Now the countries trying to open their Sukuk market to retail investors. The Sukuk has got a different structure, while Standard number 7 of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) states 14 classes of permissible Sukuk structures. The following are the most used Sukuk structure [22].

i- Sukuk ul Ijara (Lease)
ii- Sukuk ul Wakala (Agency)
iii- Sukuk ul Musharaka (Partnership)
iv- Sukuk ul Mudarabha (Joint venture)
v- Sukuk ul Murabaha (Cost plus transaction)

5.4- Others Islamic Financial Institutions:

OIFIs include institutions in the form of investment firms, leasing companies, microfinance institutions, etc. they are regularly involved in these areas like real estate, finance, fintech, health, and small businesses, etc. which plays a vital part in different forms and different sectors for the development and growth of the society.

5.5- Islamic Funds

These funds must abide by Islamic law and include different mixed assets structure. Malaysia showed dominancy by launching 41 mutual funds in the top three followed by Pakistan 32 and Indonesia 31 [49]. In the recent decade, the UK has appeared as the largest financial marketplace in the western world for Islamic funds which were less affected as compared to conventional funds during financial crises [62].

Global Islamic Finance Assets Distribution 2017

Sector	% of Islamic finance	US$(Billion)	No. Institutions/instruments	Countries
Islamic banking	71	1721	505 - Including windows	69
Sukuk	17	426	2590 -Sukuk outstanding	25
Islamic funds	4	110	1410 - Funds outstanding	28
Takaful	2	46	324 -Takaful operators	47
Other Islamic financial institutions	6	135	560 - OIFIs - Other Islamic financial institutions	49

Islamic finance development report 2018.

5.6- Corporate Social Responsibility

Islam wants to promote charity and helps each other through kindness. The priority of the Islamic financial system as a motive to achieve societal well-being as per Shariah [63]. The report further showed that US$ 518 million funds were disbursed by the Islamic financial institutions as a corporate social responsibility but only 28% reported in their annual reports. The CSR funds include that is, zakat, Qard-e-Hasana, and charity, etc. which were distributed among the poor people. The report further shows that Saudi Arabia and UAE are two of the largest Islamic finance markets, distributed the largest totals of corporate social responsibility funds [49].

5.7- Islam and Microfinance

Islamic microfinance institutions use leasing agreements to avoid interest and charge the fee for investment goods while keeping the ownership of these goods. A study findings exhibited that Islamic microfinance institutions have a higher outreach, minimum credit risk, and lower profitability [14]. Most of the Islamic MFIs offer Murabaha and Qard e Hasana loans as a financial product. Under Murabaha financing which is considered as the largest and most popular financial product where the financial institutions purchase an asset on behalf of the purchaser and resell on a cost-plus profit [14]. While Qard e Hasana loan bears no interest. The principal amount will be reimbursed to fund's provider and usually paid in installments.

6- Discussion and Conclusion

Islamic finance has got the attention of the individuals and business class in the global financial market. The system has successfully performed its role in the best interest of its stakeholder to achieve societal well-being. There was a time where conventional banks were competing with non-banking financial organizations but now facing great challenges from Islamic banks as well. Its fastening growth and recognition considered to be a great achievement not only in Muslim but the non-Muslim world also. Now, the countries are trying their best to strengthen their financial system and want more elasticity to absorb the shocks of the financial crises in different eras. Marketing and awareness campaigns are needed at the national and international levels for better performance and healthy competition. An idea about Islamic banks and finance should be introduced especially in the non-Muslim countries which can become a potential Islamic financial market. More Islamic bank's branches may also be established in the Muslim world as the number of conventional bank branches are more than their counterparts. The Sukuk market is also expanding gradually in the Muslim and non-Muslim world side by side [64]. The evidence showed that Islamic mutual funds have healthier risk management as compared to conventional peers [65].

No doubt the challenges and difficulties encountering the Islamic financial system may have an impact on the growth of different financial instruments. To gain more share in the global financial market there is still need a long way to go. Due to distinct financial features from the traditional financial system, the Islamic financial system is a core area for research scholars, academics, and policymakers.

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