**CHAPTER 3: Introduction to the Islamic financial system**

1. **Explain financial system and their participants.**

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| A *financial system* refers to the set of rules or arrangements related to various aspects of finance or the financial industry in helping participants to achieve a common goal, which is typically related to the productive use of funds.  The users of the facilities provided by a financial system are people, corporations and other organizations as well as government agencies, known collectively as *institutional units*. They interact with each other to channel funds to the end users of the financial system, i.e. the ultimate lenders and borrowers. *Lenders* are those willing to lend their financial surplus, which arises when income exceeds consumption. *Borrowers* are those with financial deficit, which arises from having to incur financial liabilities (debts) or the result of accumulating financial assets in the past.  Financial systems can operate at the micro, macro and global levels. At the *micro level,* i.e. household and firm specific level, the financial system is related to a set of implemented procedures in tracking the financial activities of the individual or firm such as the position and change in the revenues, expenses, assets, liabilities and capital. At the *macro level*, a financial system involves the exchange of funds between lenders and borrowers through organized financial markets and intermediaries within the country and across countries. At the global level, the financial system not only encompasses financial markets and intermediaries but also includes the central banks and finance ministries, the International Monetary Fund (IMF) and the Bank of International Settlement, the World Bank and other major institutions involved in international lending, such as private banks and hedge funds and regional institutions such as the Eurozone. |

1. **Distinguish the styles of financial systems.**

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| Financial systems can be classified into market-based (decentralized financial systems) and bank-based (centralized financial systems), depending on the relative importance of banking and stock market institutions in the country.  In a *market-based system* (e.g. Anglo-Saxon countries like the UK and the US), the market institutions are often well developed, and household assets are allocated in the form of shares and bonds. Businesses raise capital through IPOs (initial public offerings) and corporate equities. The ownership structure of companies is often very diluted and dominated by institutional investors who play a major role in the efficiency of the capital market. Monitoring is conducted by the capital market's authorities, securities commissions, special government entities and rating agencies. Market-based systems rely heavily on information quality and accounting transparency.  On the contrary, in *bank-based system* (e.g. Germany and Japan), the capital markets are relatively under-developed, and the main role of financing is played by banking institutions. Assets of households are to be allocated as claims on banks and insurance companies. The majority of companies are not listed and for those that are listed, there are limited numbers of major shareholders and institutional investors play a minor role. In such a system, the relationship between financial intermediaries and companies are of a long-term nature and are based on mutual information-sharing. Such relationships decrease information asymmetry and borrowing costs. Financial monitoring is conducted by banks that monitor investment projects and they will intervene, if necessary. |

1. **Discuss the underlying principles of an Islamic financial system.**

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| An *Islamic financial system* is a system based on the flow of funds from the surplus spending unit to the deficit spending unit which is governed by a set of divine rules and regulations embodied in the *Qur’an* and *Sunnah,* such as avoiding *riba* (usury or interest), *gharar* (ambiguities and uncertainties), *maysir* (gambling), *haram* (dealing in unlawful activities), and avoiding unethical or immoral transactions such as market manipulation, insider trading, short-selling, etc. |

1. **Explain the concept of *al-ghorm bil ghonm*.**

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| Islam enjoins risk-aversion and prohibits risk-avoiding behaviour. *Risk aversion* from an Islamic perspective refers to willingness to take more calculated risks with the expectations of earning higher returns, which is based on the principle of *al-ghorm bil ghonm* (no reward without risk). This legal maxim asserts that profit can only be acquired by taking a risk. The behaviour is in direct contrast to *riba* where taking a risk is absent from the taking of surplus out of a loan and it also allows capital to increase without any possibility to decrease. *Risk avoiding* behaviour is prohibited because such investors expect fixed return as well as capital protection which amount to *riba*. |

1. **Discuss the components of a financial system.**

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| There are five main components in a financial system, namely, *money*, *central banks, financial intermediaries*, *financial markets* and *financial instruments.*  *Money* refers to anything that is generally accepted as payment for goods and services or for repayment of debts in a particular country or socio-economic context. Central to the concept of money is general acceptability, i.e., as long as something is acceptable for exchange, then it can be considered as money.  *Central banks* are the national financial institutions that exercise control over key aspects of the financial system and are responsible for overseeing the monetary system for a nation (or group of nations) with the goals of managing the monetary policy, stabilizing the nation's currency and fostering economic growth without inflation.  The next component of a financial system is *financial intermediaries****.*** Financial intermediaries benefit not only lenders and borrowers but also society in general. They help to improve economic efficiency by facilitating transactions and portfolio creation, reducing transaction costs associated with lending and borrowing, easing household liquidity constraints, spreading risks over time and reducing the problem of asymmetric information.  *Financial markets* are mechanisms that facilitate the buying and selling of financial *securities* (equities and bonds), *commodities* (precious metals, oil and gas as well as agricultural products), *currencies* and other fungible items of value. These markets do not need specific physical locations to conduct transactions. With the advance in communication technology, exchange and trading can be conducted electronically in different parts of the world almost instantaneously.  *Financial instruments****,***also known as financial claims, are monetary contracts that can be created, traded, modified and settled between two or more parties. Financial instruments can be in the form of cash (currency), evidence of an ownership interest in an entity (e.g. shares) or a contractual right to receive or deliver cash (bond) or other assets (e.g. commodities and currencies). |

1. **Describe the evolution of money.**

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| In early human societies, there was no money and people engaged in *barter*, which involved the exchange of merchandise for merchandise without value equivalence. Later, some commodities assumed the role of currency as they were more sought after due to their utility. Salt, wheat, barley, cattle and even shells have been used as a medium of exchange and such money is referred to as *commodity money*. When precious metals were discovered, coins made from gold, silver and nickel were used as a basis for storing wealth and also as a medium of exchange, thus replacing commodity money. This *metallic money* was at first full-bodied money, i.e. the metallic value was equal to the face value.  Later, the full metallic money was replaced by minted coins for small denominations and paper notes for larger denominations as *tender money.*  At first the paper notes were convertible into pre-set, fixed quantities of gold and these gold standard notes were made legal tender. By the beginning of the 20th century almost all countries had adopted the gold standard, backing their legal tender notes with fixed amounts of gold.  However, after World War II, The Bretton-Woods Act made the US Dollar the default global reserve currency and only the USD was redeemable for gold. In 1971, the USD was removed from the gold standard. Other countries followed suit by abandoning the gold standard. Hence, the *paper money* in circulation today is not derived from any intrinsic value or guarantee that it can be converted into a valuable commodity (such as gold). Instead, it has value only by government order (fiat) and printed by the central bank of the respective country as legal tender.  Another form of money is *bank money*, which refers to *cheques*, *bills of exchange* and *bank drafts.* A *cheque* is an order to transfer funds from the payer’s bank account to the payee’s bank. A *bill of exchange* is a written order used primarily in international trade that binds one party to pay a fixed sum of money to another party on demand or at a predetermined date. Bills of exchange generally do not pay interest, making them in essence post-dated checks. A *bank draft* is a payment on behalf of a payer that is guaranteed by the issuing bank.  The development of computer technology and the birth of the World Wide Web in 1991 allowed transactions to take place through *electronic money* (abbreviated as e-money). *E-money* can either be centralized, where there is a central point of control over the money supply, or decentralized, whereby the control over the money supply can come from various sources.  *Centralized e-money* includes *debit cards,* *credit cards* and *charge cards* whereby currency and payments can be exchanged electronically at the point of sale instead of paper money. With a *debit card*, the payment comes right out of the checking account into the merchant's account when the card is presented at the point of sale. For a *credit card,* charges are either paid in full or finance is extended up to the credit limit offered by the card issuer as long as a minimum payment is made each month. In contrast, a *charge card* must be paid off monthly. Besides the *plastic cards* (debit card, credit card, charge card), centralized e-money includes *mobile digital wallets* (e-wallets), which are essentially systems using contactless payment transfer to facilitate easy payments by giving the payee more confidence without having to let go of the electronic wallet during the transaction. This includes *Google Wallet,* *Apple Pay* and *Apple Watch.*  *Decentralized e-money* takes the form of *crypto currency*, which is essentially a digital or virtual currency, designed to work as a medium of exchange. The appeal of virtual currency is due to its promise of lower transaction fees than traditional online payment mechanisms. Crypto currency prices are purely based on supply and demand. There are currently over 800 alternative crypto currencies, called Altcoins, such as Ethereum, Ripple and Litecoin. |

1. **Critically evaluate the concept and functions of money from an Islamic perspective as opposed to a mainstream perspective.**

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| The *concept of money* in Islam emphasizes three aspects i.e. ownership, utilization and earning of money.  **a. Ownership of money**  In Islam, ownership of all things in existence belongs to *Allah* alone and any wealth in people’s possession is only a favour bestowed to whom He chooses, to be shared with others. Since man is not the owner of wealth and only has the right to utilize it, it serves as a kind of trial and test.  **b. Utilization and spending of money**  Since wealth and money are a divine favour by *Allah* to humans, it needs to be managed and utilized in the best ways as prescribed in the *Qur’an* and *Hadith*. Firstly, there is the need to spend on those who rightfully deserve, such as parents, next of kin, the needy as well as on oneself. Islam prohibits spending money in unlawful ways and also wasting money, which has been entrusted by *Allah*. Moreover, Islam prohibits stinginess and encourages moderation and it also prohibits squandering.  **c. Earning money**  Islam encourages man to seek lawful livelihood and it is an obligation to every Muslim. The *Qur’an* and *Hadith* emphasize the importance of work.  Besides an obligation of earning money to spend on one’s family, it is also important when there is debt to pay. Islam emphasizes the obligation to pay one’s debt and to not procrastinate in doing so. Besides insisting on the need to work and to earn money, Islam also provides guidance on avoiding unlawful ways of gaining money. These include earnings from: (i) usury or interest through money lending and other *riba*-related activities; (ii) cheating through deception in weights, measures, numbers, length or size, etc., concealing defects and real profit, hiding the nature of production of a commodity, quality or its expiry date, overcharging, etc.; (iii) monopoly through hoarding and destroying competitors in the market; (iv) gambling; (v) stealing and (vi) bribery and corruption.  The Prophet approved the *functions of money* in Islam as a medium of exchange and store of value. Muslims are advised to buy and sell products using money, thus, confirming acceptance of money as medium of exchange. The role of money as a store of value is endorsed by the Prophet when *zakat* (alms) is levied on any wealth having the potential to grow. Since *zakat* is charged on monetary assets, this suggests that money is an important productive agent as it has the potential to grow and create more value. However, the use of money as commodity and for lending is forbidden in Islam. The reason is that money by itself has no intrinsic value. It cannot be sold or rented out to generate surplus value by itself. But commodities that have value in themselves such as gold (*dinar*) and silver (*dirham*) can still be used as commodity money and at the same time allow the owners to enjoy the usufruct in the commodities.  Islam forbids the lending of money to make a profit, as such practice would be tantamount to making money from money, which is *riba.* Money in Islam can only be generated through lawful trade and investment where parties share the risks and rewards. Money is only recognized as capital when it is combined with other factors of production, because money, by itself, has no opportunity cost. Only investors, who contribute capital and become partners in commerce and sharing the risks, can earn rewards.  While both Islam and the capitalist system recognize money as a factor of production, the latter treats money as capital that deserves getting rewards (technically known as interest) irrespective of the results of the productive activity.  **The capitalist and Islamic concept on functions of money**   |  |  |  | | --- | --- | --- | | **Capitalist** | **Purpose** | **Islam** | | Yes | Medium of exchange | Yes | | Yes | Commodity | No | | Yes | Purchase of goods and services | Yes | | Yes | Loan to make profit | No | |

1. **Discuss the Islamic view on the various types of money.**

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| Not all of the types of money meet Islamic criteria. *Metallic money* in the form of gold and silver and *tender money* backed by gold standard are acceptable in Islam as they reflect the actual face value. However, *paper money* that we currently use is problematic because it is not derived from any intrinsic value and there is no guarantee of the value being maintained.  When currency and payments are exchanged at the point of sale without any interest being involved, *bank* and *electronic money* are permissible. Hence, bank drafts, debit cards and charge cards are permissible. Islamic credit cards are well accepted by all customers who prefer to utilize a credit card based on *shari’ah* principles.  There are differing opinions among *shari’ah* scholars on crypto currencies’ permissibility. In certain Muslim jurisdictions the use of digital currencies and blockchain technologies to create innovation in Islamic finance, are welcomed. More recently, the Egyptian Grand Mufti, Shawki Allam, has released a *fatwa* (religious edict) against all crypto currencies, stating that crypto currencies are forbidden according to *shari’ah* is because they carry risks of fraudulence through lack of information and knowledge, which is tantamount to gambling. Similarly, the Religious Affairs Directorate of Egypt deemed Bitcoin to be contrary to Islamic rules, citing that the crypto currency was not connected to any central authority, thus carried the risks of forgery, disinformation and fraud andwould potentially cause harm to individuals, groups and institutions. |

1. **Since the foundations of central banks’ activities are based on interest, explain how they can support IFIs without jeopardizing the *shari’ah* aspect.**

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| The relationship between Islamic banks and central banks has three features, irrespective of the host country, that need particular attention: as lender of last resort, as clearing house and as supervisor in regard to monetary policy.  As a *lender of last resort*, the central bank can control the supply of money to the commercial banks and in turn the public. They can lend directly to banks to provide them with the needed liquidity in order to prevent crises, protect depositors, prevent widespread panic withdrawal, and the potential damage to the economy caused by the collapse of banks. However, these loans are given on the basis of interest accumulation, which is prohibited in Islamic finance. To accommodate the *shari’ah* requirement, central banks can provide liquidity for Islamic banks on the basis of profit and risk sharing in the form of *mudarabah* (partnership) or *musharakah* (joint venture) capital. The central bank would share in the profits from the Islamic bank’s investment of the money over the period for which the funds are advanced.  With regards to its role as a *clearing house*, the central bank can play an important part in providing Islamic banks with facilities for the settlement of cheques and other payments and services around documentary letters of credit and guarantee in return for a commission.  Islamic banks using the clearing system opens a current account with the central bank and limited short-term temporary overdraft facilities exempted of interest are occasionally allowed to cover temporary shortfalls for settlement purposes. The central bank may also allow limited short-term temporary facilities free of interest for Islamic banks on the basis that these banks would place compensatory funds of the same amount for an equivalent duration, interest free, with the central bank or on the basis of sharing in their profits for the period of the shortfall.  Lastly, as *supervisor for monetary policy*, the central bank can influence credit availability and inflation through money in order to provide a stable economic growth. The central bank is obliged to create blueprints and types of standard data needed from Islamic banks to be utilized by Islamic bank agents and the central bank itself so as to adhere to the principles of Islamic banking procedures.  However, there are some areas where different controls need to be exerted between Islamic and traditional banks depending on whether they involve interest or not; these controls include statutory cash reserve requirements, liquidity ratios, deposit insurance schemes, credit ceilings, distribution of profits of Islamic banks, inspection of banks, profit equalization fund and monetary assets. In fact, control of Islamic banks should consider their specific characteristics; their statute must be approved by the central bank before the latter gives the bank permission to operate. Central banks should have a distinctive set of guidelines for the inspection of Islamic banks as well as regulations to safeguard the interests of Islamic investors. The central bank may also evaluate the investment programmes of Islamic banks. Also, special consideration should be applied by central banks when applying credit ceilings to Islamic banks. The minimum interest rates prescribed to commercial banks to pay on savings and time deposits should be replaced in the case of Islamic banks by a weightage system to be given to these deposits for the purpose of profit distribution by the banks. |

1. **Describe the roles of the various types of conventional and Islamic financial intermediaries.**

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| Financial intermediaries consist of *banking (deposit-taking)*institutions and *non-banking (non-deposit-taking)* institutions.  *Deposit-taking institutions* include commercial banks and savings institutions whose main source of funds consist of deposits from households, businesses and government agencies while for credit unions, the source is from deposits by credit union members. In terms of use of funds, both commercial banks and savings institutions use the funds to purchase government and corporate securities, give out loans to businesses and households while credit unions use the funds to provide loans to credit union members. *Non-deposit-taking institutions* can be further classified into *contractual savings institutions* such as insurance and pension funds companies and *investment intermediaries* such as companies offering mutual funds, financial loans, investment services and brokerage houses.  As for Islamic financial intermediaries, all the activities must follow the Islamic principles. Islamic commercial banks play the role of intermediaries indirectly by buying funds through offering a variety of *shari’ah* compliant deposit products such as current accounts (*wadiah* and *qard-hassan*), savings accounts (*mudarabah*-based) and investment accounts. They then sell the funds through a variety of Islamic equity-based and debt-based financing products. Equity-based financing products facilities comprise trustee partnership (*mudarabah*), joint venture (*musharakah*) and declining partnership (*musharakah mutanaqissah*), while debt-based facilities include cost-plus sale (*murabahah*), leasing (*ijarah*), deferred delivery sale (*salam*), manufacturing sale (*istisna*), recurring sale (*istijrar*) and benevolent loan (*qard-hassan*). Some highly controversial financing products (due to differing opinions of *shari’ah* scholars) offered by some Islamic commercial banks include tripartite resale (*tawarruq*), bill discounting (*bay al-dayn*) and repurchasing (*bay al-innah*). A wide range of fee-based services, such as letter of credit (*wakalah*) and letter of guarantee (*kafalah*), is also offered by Islamic commercial banks.  The second type of intermediaries is performed by Islamic insurance (*takaful*) operators. They are contractual savings institutions that mobilize funds through a variety of *takaful* policies and the mobilized funds are, in turn, invested in *shari’ah* compliant avenues.  mutual funds and unit trusts are the third type of financial intermediaries, and they mobilize funds by selling fund units that are similar to *mudarabah* certificates and the funds are then invested in *shari’ah* compliant avenues.  In short, the primary function of financial intermediaries is asset transformation which takes place in the form of matching the demand and supply of financial assets and liabilities (deposits, credit, loans and insurance) and transforming the maturity, scale and location of the financial assets and liabilities of the ultimate borrowers and lenders. Islamic financial intermediaries also offer brokerage and matchmaking between borrowers and lenders and facilitate the demand and supply of non-tangible and contingent assets and liabilities such as collaterals, guarantees, financial services and custodial services. |

1. **Distinguish between a fully fledged Islamic bank, an Islamic subsidiary and an Islamic window, including their advantages and disadvantages.**

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| A *fully fledged Islamic bank* refers to a bank that fully operates based on Islamic principles and offers only *shari’ah* compliant products. Advantage of a fully fledged Islamic bank is the standalone management and banking infrastructure while its disadvantage is high operating costs.  An *Islamic subsidiary* is an Islamic bank leveraged on a conventional bank (parent) but with separate operations and management. Advantages of an Islamic subsidiary include medium operating cost, being still within the same banking infrastructure but with an ‘Islamic brand name’ to differentiate the services being offered and having an independent management. The main disadvantage of an Islamic subsidiary is that it may be costly to set up Islamic branches.  An *Islamic window* refers to Islamic banking products and services provided by traditional banks as an option to customers. The advantage of Islamic windows is that their operating costs are low as they are still within the existing banking infrastructure, but their disadvantages include limited range of products or services being offered and dependence on traditional bank management. |

1. **Describe the components of financial markets.**

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| Financial markets may be classified based on the nature of the assets and transactions, such as: *type of transaction* (direct or indirect); *duration or the term to maturity* (e.g. money markets and capital markets); *selling and reselling* (e.g. primary and secondary markets); *size of transaction* (e.g. retail and wholesale markets) and *style and complexity of transaction* (e.g. auction markets and over-the-counter markets).  *Money markets* deal with monetary assets of a short-term nature, usually less than a year, to enable participants to meet a temporary shortage of funds and a temporary deployment of excess funds. One specific money market is the *interbank market*, which allows banks with excess liquidity to lend their funds to other banks with a shortage of funds, often overnight and usually on an unsecured basis.  *Capital markets*, on the contrary, deal with longer term *equity capital* (shares) and *debt capital* (bonds). Capital markets can be further categorized into primary and secondary markets. *Primary markets* (new issue markets) provide opportunities for issuers of financial securities to raise capital or debt for the first time through underwriting and initial public offering (IPO). *Secondary markets* provide the platform for the exchange of existing or previously issued securities (shares and debts).  *Commodity markets* deal with the trading of raw or primary products, which can be split into two types: hard and soft. *Hard commodities* are natural resources that must be mined or extracted such as gold, oil and tin. *Soft commodities* consist of agricultural or livestock products such as coffee, wheat, corn, sheep and cattle.  *Foreign exchange or currency markets*, also known as Forex or FX, deal with the trading of currencies. |

**13. Distinguish between *shari’ah* filter, *shari’ah* index, Islamic Real Estate Investment Trusts (i-REITs), Islamic Exchange Traded Funds (i-ETFs) and Islamic Interbank Money Market (IIMM), including their advantages and disadvantages.**

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| A *shari’ah* filter, or also known as *shari’ah* screening, is the methodology applied to ensure that the activities of companies are *shari’ah* compliant. The screening normally involves two stages: the first stage of screening is based on the line of business or core business of the underlying company, i.e. not involved in non-permissible activities. The second stage is based on the company’s finances, i.e. whether involved with payments and receipts of interest.  *Shari’ah index* is an index of companies that are found to be compliant with the stringent rules of the *shari’ah* and this list is monitored by a separate body.  *Islamic Real Estate Investment Trusts (i-REITs)* are liquid assets that can be sold fairly quickly to raise cash and/or to take advantage of other investment opportunities. The advantages of investment in i-REITs are higher cash dividends relative to the market and tax benefits for foreign investors. However, there are two issues with i-REITs: the high distribution of annual profit and lower reinvestment may lead to a slower growth rate and, despite being quite stable, it is still subjected to *shari’ah* risk which restricts the scope of investment.  *Islamic Exchange Traded Funds (i-ETFs)* are similar to traditional ETFs except that the Islamic Benchmark Index comprises companies, which are *shari’ah* compliant as advised by the *shari’ah* adviser or *shari’ah* committee. Advantages of investing in i-ETFs include allowing diversification of risk, a lower expense ratio and transaction costs, higher transparency and *shari’ah* compliant investments. Disadvantages include the risk of speculation and tracking error.  The *Islamic Interbank Money Market (IIMM)* was introduced as a short-term intermediary to provide a ready source of short-term investment outlet based on *shari'ah* principles and through which the Islamic banks and banks participating in the Islamic Banking Scheme (IBS) would be able to match the funding requirements effectively and efficiently. |