Readings in Islamic Financial System

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বাংলাদেশ ইনস্টিটিউট অব ইসলামিক ফাইন্যান্স (বিআইআইএফ)

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Readings in

ISLAMIC FINANCIAL SYSTEM

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INTRODUCTION

Exigency for developing a series of readings materials on Islamic economics and finance arises from the dearth of academic literature or textbooks meant for undergraduate and graduate students at universities particularly now in Bangladesh. Islamic finance, currently a $3 trillion industry in about 75 countries of the world, is a rapidly growing sector side by side with the conventional financial system worldwide. There is a growing interest on the concept, operational procedures of Islamic economics and finance in general and the overarching need of the sector for adequately educated and trained personnel in particular. This is the first of the 10-series readings books in pipe line to meet the said requirements.

Structure of the Readings Series-1 on Islamic Financial System

The series including this one are in production line prepared following stylish standard syllabuses fit to the requirements of appropriate university level curricula adhering to object-oriented and outcome-based education (OBE) scheme. The 4-part book of series-1 consists of 16 chapters. Contents placed under each part and chapter vividly reflect depth and breadth of the content and structure of the reading series.

Readings in Islamic Financial System i.e., Readings Series-1 is a compilation of judiciously selected professional articles published in journals of international repute. While selecting the articles for a chapter from among host of similar articles, due attentions have been paid to the authority of author as well as standard and reputation of the journals in which these are published. An overview of the structure of the book below may provide instant sense of what the book is all about.

A Snapshot on how the Series is structured

The book is structured in four parts: Part I: An Overview of Islamic Financial System; Part II: Theory and Practice of Islamic Financial System; Part III: Structure and Operation of Islamic Financial System, and Part IV: Islamic Financial System and the Macroeconomic Policy.

Overview on the Islamic Financial System

Part-I, comprised of chapter 1 & 2 of this readings series, starts with a retrospective survey of recent literatures on Islamic financial system conducted by the editor of this series covering full contents and resource materials incorporated in the series.

Other contributions made in chapter-2 brings forth an overview of the concept, history, current status of Islamic finance, and issues and challenges faced by Islamic financial institutions by Zamir Iqbal (1997); Ana Belén Soage (2020), and Momtaz Hussain, Asghar Shamoradi & Rima Turk of IMF (2015). Contributors in this part discus the concept of Islamic finance and show how its application root back to the era of Islamic civilization throughout the Middle-Ages fostering trade and business activities with the development of credit and introduction of financial instruments such as cheques, bills of exchange and promissory notes. These instruments were adopted in Europe in the Late Middle Ages and became an integral part of the modern world economy (Ana Belén, 2020;). In others findings the term “Islamic financial system” is a recent phenomenon appearing only in the mid-1980s. The system is founded on the absolute prohibition of the payment and receipt of predetermined, guaranteed rate of return barring the use of debt-based instruments. A “two-window” model for Islamic financial intermediaries has been suggested wherein demand deposits are backed 100 percent by reserves, and investment deposits are accepted purely on an equity-sharing basis (Iqbal, 1997).

Islamic Financial System: Foundation, Theory and Practice

Part-II (Chapters 3-6) deals with the role, concept, theory and practice of financial system in general and Islamic financial system in particular.

Role of financial sector in the economy

Khan et al (2015) and Hamad Omar Bakar & Zunaidah Sulong (2018) in their literature survey review the link between role of financial institutions and economic growth. UNEP study (2015) reviews the banking and finance literature to summarize the current state of knowledge on the relationship between financial system characteristics and real economic outcomes and finds financial deepening generally seen as a critical enabler of economic development. While large banking institutions cannot be said to be more risky per se than small ones, large multinational banking groups can create and propagate risks in the financial system due to the scale, interconnectedness and the often complex nature of their activities. Moreover, the 'too-big-to-fail' problem may create moral hazard issues. Paun et al (2019) in their study confirm that domestic monetary and credit expansion have a negative impact on economic growth. However, the territorial expansion of the financial sector (number of branches), the increasing stocks traded and net foreign assets have a positive impact on economic growth.

Islamic financial system: concept, theory and practice

IMF study finds resilience of Islamic finance and the broad appeal of the system is partly owing to principles that govern Islamic financial activities, including equity, participation, and ownership. In theory, Islamic finance is resilient to shocks because of its emphasis on risk sharing, limits on excessive risk taking, and strong link to real economic activities. Empirical evidence on the stability of Islamic banks, however, is so far mixed. While these banks face similar risks as conventional banks do, they are also exposed to unique risks, necessitating a tailoring of current risk management practices. The macroeconomic policy implications of the rapid expansion of Islamic finance are far reaching and need careful considerations, IMF working paper (2015) emphasizes.

Laldin and Furkani (2013) view Islamic finance attempt rearranging modern financial practices in line with Sharīah principles and requirements. The industry has grown considerably and has a global reach. They view that Islamic banking and finance brings Islamic visions of economy in the financial sphere in the effort of realizing human wellbeing and a just and fair order of society. Adherence to Maqasêid al-Sharīah as the grand objective of Islam is necessary for developing genuine and indisputable 'Islamic' finance.

Regulations and laws governing Islamic financial system

Elasrag (2014), Kepli and Yazid (2013) deal with breadth of the regulatory framework that fits to the requirements of banks functioning in all of the three variant environments: fully Islamic, dual systems and neutral or partial inclusion. Fahim Khan (2007) sees the global growth of Islamic banking taking advantage of the diversity and flexibility in the fiqh opinions to meet the challenges of growth. The flexibility in fiqh opinion is presently contributing to global growth, but it may soon become a constraining factor in the global growth of the industry if the challenges arising out of the use of diversity and flexibility in fiqh are not properly recognized and regulated. Bouheni (2015) analyses issues what are special to Islamic banks on banking governance.

Developing Islamic financial system

Elhachemy & Othman (2015) investigates whether the modern application of the Islamic financial system is the new recommended architecture to promote growth and prevent the outbreak and spread of future crises, especially in Islamic countries. Other related empirical studies include Hasan and Dridi (2010), and Kassim and Abd Majid (2010) examining the impact of financial crisis on Islamic financial development. Reasons for contradictory findings between theory and empirical studies on those issues are due to insufficiency of studies carried out so far (Furqani and Mulyany, 2009) and Farahani and Dastan, 2013). ÖKTE (2017) views that the global financial crisis provided an opportunity to test the strength of the Islamic financial system and to discuss the question of whether it represents an alternative to the conventional financial system.

Structure and Operation of Islamic Financial System

Part-III (chapter 7-13) discusses constituents of Islamic financial markets and explains how each of them operates. Bank Negara, the central bank of Malaysia provides Malaysian experience in structuring Islamic financial system comprising money market, interbank money market, capital market, ṣukūk, takaful, Islamic funds and non-bank financial institutions.

Islamic money market

Malaysian experiments in Islamic banking have become significant because it has attempted to establish an Islamic money market, a feature that is absent in other Islamic banking models (Ausaf, 1997). Amin et al (2013) explain the concept of Islamic money market in the Malaysian context providing a theoretical framework of the market. They discuss also the characteristics, objectives, key players of the Islamic money market in Malaysia. Moreover, they explains the methods used by BNM to manage the liquidity of the Islamic money market and the Islamic money market instruments, which are different in terms of concepts, principles and goals.

Islamic capital market

Dina Geumei (2018) discusses the differences between the well-developed conventional capital market and the newly developed Islamic capital market. According to her, both markets are similar because they are there to fulfill the same need, yet they are different because they serve different customers. The need that they fulfill is the need for companies and governments to raise money and for investors to find profitable projects to invest in. The customers that they serve are the companies, governments and the investors. But the later serve the Muslim investors and entrepreneurs, who are trying to do business while following the laws of their religion (Shariah law). That's why they work parallel to one another.

Islamic interbank money market

Olayemi et al (2015) elucidate Islamic interbank money market, presenting a comparative legal study between Malaysia and some notable jurisdictions. Khamlichi et al (2014) contribute to the empirical literature by exploring the efficiency of Islamic equity market indices and their potentials for diversification in comparison with the conventional benchmarks.

Ṣukūk market

Zolfaghari in her paper examines ṣukūk in comparison with other securities of various aspects so that the concept and nature of ṣukūk would be more tangible and easier to understand for the reader. Ulusoy and Mehmet (2018) argue that because of the ṣukūk market problems particularly due to inactive, weak and sluggish secondary market, the potential of the ṣukūk market has not been realized yet. They studied reasons of weak ṣukūk secondary market and proposed solutions to resolve them.

Islamic unit trust

Azizi Abu Bakar (2016) examines the extent agent understands the concept of investing in Islamic Unit Trusts, the level of understanding of the Islamic Unit Trust itself and the extent to which the contribution of Islamic Unit Trust investment agent in giving insight to potential investors. Mohamed Sharif Bashir & Wan Rasyidah Wan Nawang (2011) evaluate the overall performance of Islamic and conventional unit trust funds in terms of risk, return and diversification of selected unit trust in Malaysia. Ahmad Khaliqa, Nazimah Hussin, and Mohammad Tahir Sabit Haji Mohammad in their study revisit the literature on the issue of illiquidity of Waqf assets and study how to eradicate the dependency on government provisions.

Islamic financial institutions

Thorsten Beck, Elena Carletti and Itay Goldstein (2016) focused on the recent financial crisis of 2007-08 resulting impetus not only to an intensive regulatory reform debate, but also to a deeper discussion on the role of financial institutions in modern market economies and the role of financial innovation. Nikonova Tatiana, Kokh Igor, Safina Liliya (2015) endorse the reality that Islamic financial institutions are part of the modern world economy and subject to the same economic laws as any other traditional financial market participants. The study by Fazlurrahman Syarif (2019) discusses the forms of a regulatory framework and the organizations set up for standardizing the regulations. Indonesia and Malaysia maintain a dual system of regulatory framework taking the conventional and Islamic financial system under one umbrella. Hence, the central bank has full authority to enact required laws and policy and to regulate the Islamic financial institutions in Indonesia and Malaysia.

Non-bank financial institutions

Islamic NBFIs diversify the financial services sector, make it more resilient, and help achieve greater financial inclusion (IFSB, May 2007). Monzur Hossain and Shahiduzzaman finds NBFIs as new in the financial system compared to banking financial institutions. Emergence of NBFIs has created a new avenue in the bank-dominated traditional financial system.

Islamic Financial System and the Macroeconomic Policy

Monetary theory and policy from Islamic perspective

Md. Akther Uddin (2016) reviews important theoretical and empirical literatures on Islamic monetary economics. The prohibition of *Riba* has imposed challenges on Islamic economists to come up with the viable alternatives to achieve Islamic monetary policy goals. Equity based profit and loss sharing instruments have been proposed for conducting open market operations in an interest-free economy. He discusses possibility of using a number of conventional monetary instruments such as changes in reserve requirements, overall and selective controls on credit flows, changes in the monetary base through management of currency issue, and moral suasion. Chapra (1996) observes managed money is a new phenomenon which has gained prominence after the collapse of the Bretton Woods system. There is no possibility of finding precedence for managed money in the days of the Prophet (pbuh) or in early Islamic history. A number of questions are, therefore, continually raised about the monetary system that a Muslim country may adopt.

Khan and Mirakhor (1989) and Khan (1996) attempted to develop interest-free economic model with the help of conventional ISLM framework. Mansor, H. Ibrahim and Nafis (2017) examines how Islamic economics as a discipline applies the injunctions of Sharīah in dealing with the allocation of scarce resources for individual and collective achievements of spiritual, moral and material well-beings.

Integration of Islamic banking to the global economy

Vitoriia Stoika (2019) subscribes the viewpoint that the rules of banking management in Muslim countries are based on the Sharīah Law regulating social, political and cultural aspects of Islamic society. Sharīah law also prohibits the conclusion of immoral transactions and endorses social justice, which is ensured through the distribution of risks and returns, and the implementation of social investment. In the context of economic globalization, this phenomenon is already quite distinguished and is considered a worthy competitor to the traditional banking system.

Challenges of introducing Islamic banking to the global financial market

Tahmoures A. Afshar, Majed R. Muhtaseb (2018) note that the International Monetary Fund added officially the Islamic finance in its monitoring of financial sectors around the world. There are major differences between conventional and Islamic finance that are both ethical as well as technical (Khair Bakhsh, 2011). The ethical differences are related to the ownership of wealth (assets). In Islam, ownership of wealth exclusively belongs to the God Almighty. The focus of Islam is on the social and moral responsibility of investors while in possession and control of assets. Islam forbids the concentration of wealth in the hands of a few. This invokes a spiritual element in financial transactions. The technical (legal and operational) differences between conventional and Islamic finance are substantial. This leads us to introduce the unique features of the Islamic Banking.

Islamic finance: challenges and the way forward

Vladimir Novikov, Elena Yarushkina, Elena Britikova, Lydia Kovalenko (2019) observe that the modern world financial system based on the theories and practices by western economists malfunctions and results in global crises. USA and European economists themselves doubt in this system's universality and applicability to all the countries of the world. Until recently, the Islamic economic theory excited nothing more than just academic interest among a limited circle of scientists in the Western world. Nevertheless, under the conditions of today, the Islamic economic model, its structure and mechanisms is a topical subject, as the rise in the gross national product and economic upturn are now observable in the PRC and Islamic countries. The world economic system has entered into a new stage of development, where the consequences in the globalizing world economy are hard to predict.

Challenges in realizing Maqasêid al-Sharīah in Islamic banking and finance: Asyraf Wajdi Dusuki, and Abdulazeem Abozaid (2007) examines the challenges of the proper realization of Maqasêid Al-Sharīah in Islamic banking and finance. The challenges cover various issues such as (a) the proper understanding of Maqasêid Al-Sharīah in Islamic economics; (b) the methods of implementing Maqasêid Al-Sharīah in Islamic banking and finance; (c) the potential conflicts between macro Maqasêid and micro Maqasêid; and (d) the possible abuse of Maqasêid Al-Sharīah to justify certain financial contracts which in fact contradict the Sharīah texts. Volker Nienhaus (2020) focusses on the behavioral changes and market developments in the financial and real economy that will impact Islamic finance differently than conventional finance due to its conceptual peculiarities and prevailing practices. Particular attention is given to the real estate and construction sector, the universe of Sharīah compliant stocks, and the consumer finance of Islamic retail banks. Through these channels, "the world" will have an impact on the future of Islamic finance.

The Editor