# THE ORIGIN OF CONTEMPORARY ISLAMIC FINANCIAL REGULATIONS IN ISLAMIC LAW: A SUBSTITUTE TO TRADITIONAL FINANCE

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This paper attempts to discuss the theoretical aspects of the Islamic Finance System and to remove the misunderstood concepts that the Islamic financial system involves merely the absence of interest and only applies to those who practice the Islamic faith and is unable to provide a complete financial system in comparison with the traditional financial system. The key focus of the paper is to investigate whether the framework of Islamic Finance is capable to develop a financial system that would not guide the world in the direction of financial and economic crises, which the world is experiencing presently. Whereas the proponents of Islamic Finance consider it as a start of new business avenues and a substitute to traditional financial system and economic growth. The paper explains the Islamic banking system in reference with its implementation, which takes its origin in early 1980's in the Middle East, Saudi Arabia, Malaysia, Iran and Pakistan.

**Keywords:** International Financial Institutions, Islamic Finance, International Monetary Fund, World Bank, Shari'ah, Musharakah, Mudarabah.

## 1.1 INTRODUCTION

The International Financial Institutions (IFIs) are the aftermath of second world war especially the Bretton woods institutions. In 1944, a year before the end of Second World War, the Bretton woods institutions were set up at the Conference in New Hampshire.[1] According to Abouharb and Cingranelli, the IMF was established because of the belief that the international world had been unable to address the financial problems that confronted "Germany during the late 1920s and early 1930s". However, the World Bank was set up to cope with the economic instability of post-World War II Europe and subsequently, the financial well-being of the developing world. The bank first focused on project lending[2] until the late 1970s and then shifted from 'project to structural adjustment lending' in the 1980s. These lendings attached with policy conditions proposed to encourage financial development while emphasizing macro-economic factors as well as structural factors.[3]

The SAP takes its origin in 1980s in the aftermath of the debt crisis of early 1970s and the Organization of Petroleum Exporting Countries (OPEC) enhanced the rates of petroleum products at that

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time whereas deposited their profits in the western banks. These banks planned to disburse loans to the developing countries with the understanding that these countries will buy the commodities of industrialised states. The industrialised countries introduced a chain circle to generate more money from these loans as well as to explore markets for their industrial products.[4] George notes that developing countries borrowed money from these banks for development sometimes at low interest rates. However, the studies indicate that most of the lending money has wasted in useless projects or looted by the corrupt elites.[5]

In early 1980s, the U.S. Federal Reserve increased interest rates considerably to reduce inflation and as a result, the developing countries, which borrowed money at cheapest interest rates, were compelled to pay back at higher interest rates. The situation led to the debt crisis and pushed these countries to sign up new loans for the payment of old ones. Many paid back monies borrowed but remained highly indebted. A classic example is Mexico, which announced in 1982 that it was unable to pay its debts. This situation created an opportunity for the World Bank and IMF to step in by offering new loans in the shape of SAPs attached with certain conditionalities.[6]

The World Bank and IMF introduced the Structural Adjustment Programs (SAPs) for the improvement of financial stability and speedy economic growth of developing countries. The main purpose of the SAPs was to decrease the monetary inconsistency of the loan receiving countries that ensured the borrowed money would be utilized for the specific purpose of the loan. In 1981, the proposal of SAPs got its origin "when the administration in the U.S. and Thatcher administration in the UK" and their coalition partners suggested that further conditionalities be attached to loans to the developing countries.[7] The World Bank and IMF designed SAPs for developing countries with a special focus on "macro-economic conditions" which were declared mandatory before applying for lendings to these financial institutions. The main characteristics of the SAPs were "Privatisation, Liberalisation and Economic Stabilisation measures". Unfortunately, the SAPs failed to achieve the targets and aggravated poverty rather than alleviate it.[8] Bryceson and world Bank and Dibua notes:

> Neo-liberal policies, championed by the World Bank and International Monetary Fund (IMF) …have not secured

> 'economic take-off'. Rather there has been growing immiseration through livelihood displacement, physical infrastructural decay, and social service breakdown.[9]

In 1971, the United States of America was unable to fulfil its obligations any more to a definite gold worth of the dollar as the stable exchange rate system distorted in the aftermath of Second World War. Currently, the use of gold standard is neither possible nor required. However, in 1997-8 South East Asian markets practiced instabilities in exchange rate are merely a slayer[10]. The Human Development Report of 1999 established the risks of liberal fluctuating exchange rates as well as indicated significant reforms mentioned below:

> When the market goes too far in dominating social and political outcomes, the opportunities and rewards of globalization spread unequally and inequitably—concentrating power and wealth in a select group of people, nations and corporations, marginalizing the others. When the market gets out of hand, the instabilities show up in boom and bust economies, as in the financial crisis in East Asia and its worldwide repercussions, cutting global output by an estimated $2 trillion in 1998–2000. When the profit motives of market players get out of hand, they challenge people's ethics and sacrifice respect for justice and human rights[11].

In acknowledgment of the increasing importance of Islamic finance amid Asian Development Bank (ADB) developing member countries (DMCs), ADB linked the Islamic Financial Services Board (IFSB) as a spectator fellow in December 2003. IFSB is formed as a standard organization for the Islamic monetary system, and offers a forum for guiding and monitoring groups and commercial bodies advising Islamic commercial amenities to deliberate significant problems on regulation and management. ADB and IFSB initiated debates on the prospective for association in the growth of global prudential criterions for the management of Islamic economic amenities, and a technical assistance (TA) scheme was established. A collaborative international colloquium on "Challenges Facing the Islamic Financial Services Industry" was structured by the Islamic Development Bank (IDB), International Monetary Fund (IMF), and IFSB followed by a number of deliberations and recommendations emphasize on (i) evolving comprehensive international prudential criterions, (ii) appraising and evaluating IFSB member statistics to maintain evaluations for the growth of suitable prudential criterions, and (iii) supporting the growth of legal structures for Islamic finance.[12]

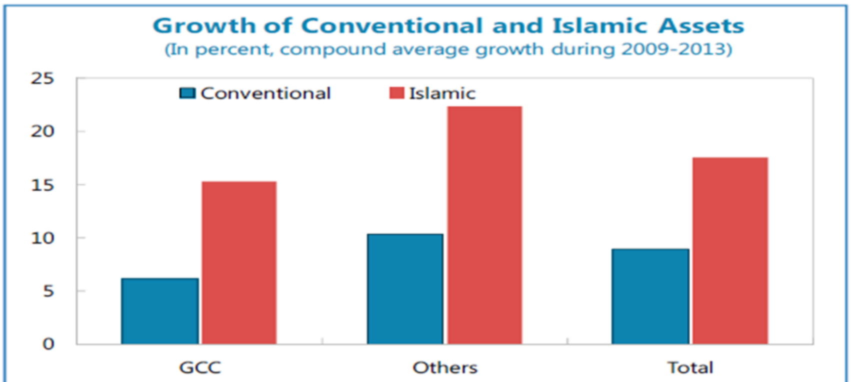
The conventional finance led financial crisis provides a gap in International Financial System which paved a way forward for Islamic Finance as mentioned above. The Islamic finance may provide a solution of the problem but a detailed study may possibly answer this question how and in what way.

## 1.2 THE ORIGIN OF ISLAMIC FINANCE

The establishment of Islamic financial institutions is comparatively a fresh edifice. It was started from Egypt in early sixties and one of the first Islamic banks was established there in 1963. In fact, a contemporary model of Islamic banking was originated in Egypt; however it did not flourished as a strong financial institution devoid of the robust backing of Saudi stakeholders. The Islamic banking program acquired strength after the establishment of Islamic Development Bank (IDB) in 1975. It was a notable moment of contemporary Muslim history that an international financial institution devoted itself to manage its affairs in conformity with Islamic financial regulations i.e. *Shari'ah*. It started with interest (Riba) free banking; however the bank administration was allowed to impose fee charges in reward of its administrative overheads. Since the formation of the IDB, some other Islamic banks established globally and various countries took initiatives to consolidate their banking system in lines with *Shari'ah* banking. In 1975, the Dubai Islamic Bank as first private Islamic commercial bank started its business in lines with *Shari'ah.*[13]

The Islamic *Shari'ah* banking system got its strength in the last four decades and shows a marvelous growth as compared to the conventional banking system. The International Islamic monetary amenities extended an aggregate worth of US $ 1.9 trillion as per mid of financial year 2014 whereas 3/4 % of the business focused in the middle-east and North America. Furthermore, it is expected to have exceeded the $2 trillion landmark by the end of financial year 2014. The graph 1.1 below shows the growth of Conventional and Islamic assets.[14]

GRAPH 1.1 GROWTH OF CONVENTIONAL AND ISLAMIC ASSETS




Source: Ernst and Young (2015).
Note: Countries include Bahrain, Egypt, Indonesia, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Turkey, and United Arab Emirates.

In recent, the future of Islamic banking system is predicted bright due to its healthy progress. However, in order to understand the complexities of the system, it is indispensable to understand its structure and key features.

### 1.3 KEY FEATURES OF ISLAMIC FINANCE

There are certain significant features of Islamic Finance which differentiate it from conventional finance.

#### 1.3.1 Riba (Interest)

Riba is originated from the derived word "raba-wa" which means to rise; to develop; to flourish, to exceed, in excess of. However, in its literal significance Riba is usually interpreted into English as usury or interest but actually it has much comprehensive sense under Sharia.[15] The Quran specifically forbids *riba* (interest) as mentioned in the subsequent verses of the Holy Quran:

> *'What you give in riba to increase in people's wealth, does not gain anything with God. But if you give charitably, seeking God's pleasure, these are those who receive manifold reward'.*[16]

In another verse of Quran Allah (s.w.t) says:

> *'... they say that trade is like riba, but God hath permitted trade and forbidden riba'.*[17]

Further, Allah (s.w.t) says in Quran:

> *'O ye who believe! Fear Allah, and give up what remains of riba, if ye are indeed believers'.*[18]

In sura Nisa Allah (s.w.t) says:

*'And because of their charging Riba, whilst they were prohibited from it'.*[19]

Riba may be defined as any profit on money that is fixed in sum and consequently comprises existing practices of interest-based financing.[20]

### 1.3.2 Gharar (contractual uncertainty)

Gharar is an Arabic language word having equally extensive perception that exactly means deception, assumption, extreme risk, dishonesty, ambiguity or peril that might result in devastation or damage to the consumer. As a notion, it is established on the doctrines of fairness and effectiveness in trades. The existing situation on *gharar* in sharia is that its presence in a contract is forbidden in Islam and may assert the contract invalid. Therefore, it is mandatory for contracting parties to reveal all the terms and conditions of the contract. However, some other scholars have varied opinions about *gharar* that it is forbidden in Islam.[21] Though, there is no particular evidence from the Holy Quran that signifies *Gharar*,[22] however, Allah (s.w.t) says:

> *'Eat not your property among yourselves unjustly by falsehood and deception, except it be a trade amongst you by mutual consent'.*[23]

### 1.3.3 Gambling (Maysir)

The exact meaning of Maysir is gambling. Islam has also specifically forbidden all practices of gambling. Maysir talk about easy ways to earn riches by luck, whether or not it dispossesses the rights of the other people. In the Quran, Allah (s.w.t) explicitly forbids gambling.[24] Nightclubs run their business which is a common example of Maysir. In Nightclubs, the money travels from the loser to the victorious devoid of generating any healthy business activity. In short, contracts containing pure assumption, predictable cover and byproducts are in the definition of Maysir. Businesses based on speculations in the investment marketplace generally are observed in suspicion by sharia boards and evaded by monetary organizations.[25]

### 1.3.4 Hoarding

Islam always appreciates trade and business as it makes riches for people and is fortified between individuals in some profit and loss distribution. Whereas hoarding, instead, in any form, is severely forbidden as it produces a sense of shortage and shatters public wellbeing.[26] ALLAH says in Quran:

> Verily! Those who disbelieve and hinder (men) from the Path of Allah, and from Al-Masjid-al- Haram (at Makkah) which

> We have made (open) to (all) men, the dweller in it and the visitor from the country are equal there [as regards its sanctity and pilgrimage (Hajj and 'Umrah)]. And whoever inclines to evil actions therein or to do wrong (i.e. practise polytheism and leave Islamic Monotheism), him We shall cause to taste a painful torment.[27]

Prophet ﷺ says: "The boisterous is prosperous and hoarder is cursed."[28]

### 1.3.5 Prohibited Transactions/Investments

Islam provides a complete way of life and forbids all kinds of trade containing forbidden components for example pork, liquor, weaponries, deeds comprising assumption, gambling and any kind of sin. In addition, Islamic societies may have concerns about (and abstain from) investments relating to trades for instance hoteling and the leisure business that offer products such as pork, liquor, tobacco, pornography, wagering and everything that is declared by Islam 'Haram'(prohibited).[29]

## 1.4 STRATEGIES OF PROCEDURE IN ISLAMIC FINANCE

In recent, there are several elementary and significant types of financing that are very common in Islamic finance for example Musharaka, Mudharaba, Murabaha and Ijara.

### 1.4.1 Musharakah (joint risk)

A joint scheme established on Musharakah contains a business wherein both the bank and its consumer add to entrepreneurship and investment. Musharakah in the perspective of commerce and trade means a common initiative in which all the partners share the profit or loss of the common project. In Musharakah profits are distributed among the bank and the consumer in the pre-agreed proportion but losses are shared severely in percentage to their corresponding investment shares.[30]

### 1.4.2 Mudharabah

Mudarabah is a different form of business among two types of shareholders where one offers the investment and known as rabb-ul-maal whereas another provides operational and managerial services to the business and known as amil or Mudarib.[31] Muslim scholars specify the role of former shareholder as sleeping partner for which he or his agent cannot intervene into the managerial or procedural affairs of the business except to provide the finances.[32] The later i.e. amil is entirely liable for all matters relating to the business.[33] However, the profit will be allocated in a pre-decided proportion but in case of loss only *rabb-ul- maal* suffer it.[34] In case, if loss has occurred due to the negligent behavior of Mudarib then he will be guilty of contributory negligence. Moreover, all the properties procured by Mudarib are exclusively possessed by rabb-ul- maal and Mudarib is only entitled for his pre-determined share in the profit only.[35]

### 1.4.3 Murabaha

Murabahah is a contract which builds a relationship between the bank and the consumer as a seller and a buyer respectively. The sales amount is the banks' buying rate from the contractor plus other certain benefits. All the parties are required to agree on the amount and disbursement terms. In this type of business the things are supplied immediately when the agreement is finalized whereas the amount of goods is provided later. Murabahah is a specific type of transaction where the supplier explicitly indicates the price of the sold goods he has acquired, and sells it to someone else for some extra income thereon. Therefore, it is different from a loan given on interest but some transaction of goods on payment of money or on deferred amount.[36]

In Murabahah the bank, apprise the consumer of its purchase amount of merchandised products and inform the consumer about the profit added therein beforehand. However, the negotiations between the parties are possible to be agreed on some price with consensus but it must be assured that nothing is to be concealed in the agreement. There is some diverse view amid researchers in reference with reimbursements on voluntary payment.[37]

### 1.4.4 Ijarah

Ijarah is one of the Shariah agreements practiced by the Islamic Financial Institutions (IFIs). It is a form of "lease" which exactly describes as "to compensate" and "to give something on rent" but in principle, ijarah is an agreement of allocation of ownership of usufruct or service in exchange for a stated concern. The key object of lease is to enable a lessee who does not expect to possess certain properties but want to get benefit of it by using the properties against an amount of certain pre-decided leasing to the lessor. In an Ijarah contract, there are contracting parties i.e. a lessor and a lessee who are legally entitled to enter into the contract. The agents may sign an Ijarah contract on behalf of their respective contracting parties. It is important to mention here that there may be more than one owners but it is mandatory to seek the consent of all owners before the completion of lease contract. Moreover, the properties and usufruct must be possessed by the lessor at the time of lease agreement.[38]

### 1.4.5 Sukuk (Islamic bonds)

There are five fundamental differences between Sukuk and conventional Bonds as mentioned below in table 1.1

TABLE 1.1 DIFFERENCES BETWEEN SUKUK AND CONVENTIONAL BONDS

| **Sr. No** | **Sukuk (Islamic Bonds)** | **Conventional Bonds** |
|---|---|---|
| 1. | Sukuk specify ownership of a property. | Bonds specify a debt responsibility |
| 2. | The properties that support sukuk are acquainted with Shariah principles. | The properties that support Bonds can contain goods or facilities that are contrary to Shriah principles. |
| 3. | Sukuk are assessed according to the price of properties backing them. | Bond appraising is established on credit evaluation. |
| 4. | Sukuk value increased automatically with the rise of property price. | Bond value relates with static interest, forming them Riba. |
| 5. | Selling of Sukuk means selling ownership of the assets backing them. | Selling Bonds is merely a transaction of debt. |
| 6. | Negotiability is regulated to particular kinds of Sukuk | Negotiable commercial paper |
| 7. | Return of financier's assets cannot be assured | Issuer is obliged to return depositor's assets. |

Source: Naveed Mohammed, Five Important Differences between Sukuk and Traditional Bonds. (Sukuk, 2014) https://www.sukuk.com/education/important-differences-sukuk-traditional-bonds-2207/

As per the various above-mentioned scholars of Islamic Financial system, there are various distinct key features and strategies, which provide a comprehensive mechanism of financing always for the welfare of investor. In order to understand disagreement of Islamic banking system with conventional banking system, a clear comparison has been provided in table 1.2 mentioned below.

TABLE 1.2 COMPARISON OF ISLAMIC BANKING SYSTEM WITH CONVENTIONAL BANKING SYSTEM

| Sr. No | **Conventional Banking System** | **Islamic Banking System** |
|---|---|---|
| 1. | Its functions and procedures | Its functions and procedures follow |

| | | |
|---|---|---|
| | are based entirely on man-made doctrines. | the teachings of the Quran and the Sunnah. |
| 2. | All the businesses i.e. borrowings and lendings are carried out with interest. | Interest (Riba) free economy carried out through sharia rules. |
| 3. | The relationship between customer and bank is such as loan, creditor and debtor. | The relationship between customer and bank is such as Vendor, purchaser and partner. |
| 4. | Earn revenue from static interest charged to the consumer. | Earn revenue from profit-loss sharing; the bank prefers to invest on project development. |
| 5. | Generally focus on its own interests rather to secure customer’s benefits. Very often it results in the banks own interest becoming prominent. It has no subsequent purpose to make sure development with honesty. | Islamic banking system Provides primary attention to the public interest. Its subsequent purpose is to make sure development with honesty. |
| 6. | The conventional banking system delivers funding absolutely by contributing cash credits. | Islamic banking system does not offer funding by presenting cash credits. However, all the affairs are carrying out through Musharaka. |
| 7. | The bank keeps secret all the affairs relating to the investment of depositors and does not provide any information where the money invested. | Islamic banking system updates the investors about their money invested at various projects. |
| 8. | borrows money from the investors and disbursed interest as a liability and nothing any more. | builds a partnership (Mudaraba) or profit and loss sharing plan amid the bank and the investors. |
| 9. | The conventional banking system pools together the entire reserves. | keeps principal assets and depositor's assets combined in order not to mix up the earnings made on its own reserves. |
| 10. | Transactions are based on monetary benefit. | Transactions are based on actual benefit. |
| 11. | It can charge extra cash (fine and compounded interest) in case of defaulters or early settlement of loans. | Islamic banks did not charge any additional cash from the defaulters apart from reparation (usually such cash goes to charity) on early payment at the bank’s pleasure. |

## CONCLUSION

The International Financial Institutions (IFIs) are the result of Second World War particularly the World Bank and IMF. These institutions were established initially to accommodate the war-torn Europe, which later turned its focus towards the third world countries. The key objective of these institutions was to focus on destabilized international world as well as to attract business around the world. They focus on Project lending to Poverty Reduction Strategy Papers (PRSPs) but unfortunately, majority of them badly failed or did not achieve the required results due to various known or unknown reasons. The proponents of Islamic Finance argue that interest based economy of International Financial Institutions as one of biggest hurdle on the way to success. Whereas, the opponents of Islamic Finance states that it lacks a comprehensive system of finance to lead the world to avoid financial crises in the future. It is true that the Islamic Finance, which is interest free economy, provides a platform to guide the world to build a better financial system as it offers a scheme for the welfare of investors. However, there is a need to rationalize the various aspects of Islamic Financial system in a more comprehensive and competitive as it aspires to replace the traditional financial system. In the beginning, various uncertainties were there on the way to progress but currently Islamic banking system is more stable and progressing. In the last two decades, the figures show some substantial profits, which actually based on interest free business. It is worthwhile to mention here that a lot of amount has donated for charity out of this business of Islamic banking system. The characteristics and strategies of procedure in Islamic Finance provides much better options to the depositors in comparison with the traditional financing especially the Bretton-wood institutions who always look for the geostrategic interests of the powerful nations.

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