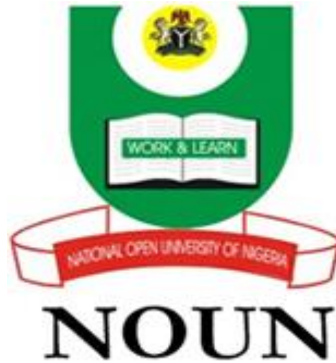


**NATIONAL OPEN UNIVERSITY OF NIGERIA**

# ISLAMIC FINANCIAL SYSTEM

## COURSE CODE: ECO728

**COURSE GUIDE**

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## Introduction

Islamic financial system (ECO 728) is a two credit course for postgraduate students studying Islamic Finance. The course is relevant to students and financial institutions in exploring an understanding of the theory and practice of Islamic financial system as an alternative to conventional financial system. The course provides necessary guide for the establishment of an alternative system despite the dominance of the conventional financial system globally.

It assists in capacity building of students and practitioners towards manpower training and development to meet the increasing need for knowledge and practice in Islamic finance.

The course guide gives what the Islamic financial system entails, the guiding principles of its operations, institutions and products. It also offers course materials to use for the course, objectives to be achieved, and some tutor marked assignments to guide and stimulate understanding. In addition, tutorial sessions would be held with the course facilitator and would encourage mutual interactions with your fellow course mates.

## Course Content

The key issues covered in the course include overview of Islamic financial institutions, its features, governing principles, products, institutions, Shari'ah and regulatory framework.

The course will give an in-depth understanding of the following issues:

- Overview of Islamic finance
- Basic principles of its operations
- Unique features of its products and services
- Distinguishing characteristics in comparison with the conventional finance
- Functions and significance of its establishment
- Key financial instruments used in transaction
- Regulatory framework of the system and institutions
- International standard setting institutions for Islamic finance

## Course Aims and Objectives

This course is designed to build your capacity to meet up with the aspiring need of the finance industry in the competitive environment of financial dualism and sustainability of intermediation role of the financial sector.

The course aims at equipping students at the postgraduate level with the knowledge of theory and practices of Islamic financial system and to serve as a mechanism for enhancing manpower development in the financial industry.

At the end of the course period, students are expected to:

- Get an insight into the theory and practice of Islamic finance in a competitive finance industry.
- Understand the main ideas behind Islamic financial system its components and functions.
- Comprehend the basic principles guiding the operations of the system and its integral parts.
- Learn the basic contracts and products employed in transaction and how they are applied in service provision.
- Recognize basic institutions that regulate the activities and standards of Islamic finance industry.
- Evaluate the efficiency or otherwise of the system in meeting the aspirations of the financial services of the individuals and institutions.
- Understand the roles financial institutions play in financial intermediation.
- To know the different Shari'ah rulings applicable to the Islamic financial products and services.
- To learn about the Islamic financial industry in Nigeria and its institutions.
- Know some of the challenges facing Islamic finance industry in efficient service delivery.

**Working through the Course**

To successfully complete this course, you are required to read the study units, referenced books and other materials on the course.

Each unit contains self-assessment exercises called Student Assessment Exercises (SAE). At some points in the course, you will be required to submit assignments for assessment purposes and write a final examination. This course should take about 15weeks to complete and some components of the course are outlined under the course material subsection.

**Course Material**

The materials needed for this course are:

1. Course guide
2. Study unit
3. Textbooks
4. Assignment file

5. Presentation schedule

**Study Unit**

There are eleven (11) units in this course that are required to be studied carefully:

**MODULE 1: INTRODUCTION TO ISLAMIC FINANCIAL SYSTEM**

UNIT ONE: Overview of Islamic Financial System

UNIT TWO: Growth Drivers of Islamic finance

UNIT THREE: Fundamental Principles of Islamic Finance

UNIT FOUR: Models of Islamic Finance

**MODULE 2: STRUCTURE OF ISLAMIC FINANCIAL SYSTEM**

UNIT ONE: Islamic Financial Markets

UNIT TWO: Islamic Financial Institutions

UNIT THREE: Islamic Financial Instruments

UNIT FOUR: Islamic vs Conventional Financial System

**MODULE 3: REGULATORY FRAMEWORK OF ISLAMIC FINANCIAL SYSTEM**

UNIT ONE: Rationale for Regulations of Islamic Finance

UNIT TWO: Regulatory and Supervisory authorities for Islamic Finance

UNIT THREE: International Standard-Setting organizations for Islamic finance

Each study unit will take at least two hours, and it should include the introduction, objective, main content, self-assessment exercise, conclusion, summary and reference. Other areas border on the Tutor-Marked Assessment (TMA) questions. Some of the self-assessment exercises will require discussions, and brainstorming with students/colleagues. A student offering the course is advised to do so in order to understand and get acquainted with the workings of conventional financial system.

There are also textbooks under the reference and other (on-line and off-line) resources for further reading. They are meant to give you additional information if only you can lay your hands on any of them. You are required to study the materials; practice the self-assessment exercises and tutor-marked assignment (TMA) questions for an in-depth

understanding of the course. This will enhance learning and understanding to achieve the objectives of the course.

**References**

Every unit contains a list of references and suggestions for further readings. Try to get as many as possible of the reading materials listed. The references are meant to enhance your knowledge of the course. The following references are recommended for further readings:


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USEFUL WEB ADRESSES

islamic-finance.startpagina.nl/ Dutch portal
www.al-islaam.com Conservative Dutch-language
website
www.cpifi nancial.net/ Islamic Business & Finance
online
www.djindexes.com Dow Jones Islamic Market
Index series
www.failaka.com Site of an Islamic consultancy;
many articles on the theory and practice of Islamic banking and
finance
www.ftse.com/indices Various Shariah Index series
www.gcu.edu.pk/Library/islam.htm Islamic Resources of the

library of Government College University, Lahore; includes
complete Hadith collections
www.irti.org Islamic Research and Training
Institute (IRTI), Jeddah; thorough
studies in the Institute's
online Occasional Paper Series
www.iifm.net International Islamic Financial
Market (IIFM)
www.iirating.com Islamic International Rating
Agency (IIRA)
www.isdb.org Islamic Development Bank;
parent organization of IRTI
www.islamicity.com/fi nance US site devoted to Islamic
economics
www.islamic-finance.com Information on Islamic fi nance,

**Assignment File**

Assignment files and marking scheme will be made available to you. The file presents you with details of the work you must submit to your tutor for marking. The marks you obtain from these assignments shall form part of your final mark for this course. Additional information on assignments will be found in the assignment file and later in this Course Guide in the section on assessment.

There are three (3) assignments in this course. The three course assignments will cover:

Assignment 1 - All TMAs' question in Units 1 – 4 (Module 1)

Assignment 2 - All TMAs' question in Units 5 – 8 (Module 2)

Assignment 3 - All TMAs' question in Units 9 – 11 (Module 3)

**Presentation Schedule**

The presentation schedule included in your course materials gives you the important dates for this year for the completion of tutor-marking assignments and tutorials. Remember, you are required to submit all your assignments by due date. You should guard against falling behind in your work.

**Assessment**

There are two types of the assessments for the course. First are the tutor-marked assignments; second, there is a written examination.

In attempting the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines set in the Presentation Schedule and the Assignments File. The work you submit to your tutor for assessment will account for 30 % of your total score for the course.

At the end of the course, you are required to sit for a written examination of three hours' duration. This examination will also account for 70% of your total course mark.

**Tutor-Marked Assignments (TMAs)**

There are three tutor-marked assignments in this course. You will be required to submit all the assignments within the stipulated time. You are encouraged to work out all the questions thoroughly. The TMAs constitute 30% of the total score.

Assignment questions for the units in this course are contained in the Assignment File. You will be able to complete your assignments from the information and materials contained in your set books, reading and study units. However, it is desirable that you demonstrate that you have read and researched more widely than the required minimum. You should use other references to have a broad viewpoint of the subject and also to give you a deeper understanding of the subject.

When you have completed each assignment, send it, together with a TMA form, to your tutor. Make sure that each assignment reaches your tutor on or before the deadline given in the Presentation File. If for any reason, you cannot complete your work on time, contact your tutor before the assignment is due to discuss possibility of an extension. Extensions will not be granted after the due date of submission unless under exceptional circumstances.

**Final Examination and Grading**

The final examination will be for maximum three hours duration and constitutes a value of 70% of the total course score. The examination will consist of questions which reflect the types of self-assessment practice exercises and tutor-marked problems you have previously encountered. All areas of the course units will be assessed

You are encouraged to revise the entire course material using the time between finishing the last unit in the module and that of sitting for the final examination. You might find it useful to review your self-assessment exercises, tutor-marked assignments and comments on them before the examination.

**Course Marks Allocation**

Table 1 below indicates the total marks (100%) allocation.

| Assignment | Marks |
|---|---|
| Assignments (Best three assignments out of four that is marked) | 30% |
| Final Examination | 70% |
| **Total** | **100%** |

**Course Overview**

Table 2 below indicates the units, number of weeks and assignments to be taken to successfully complete the course.

| Units | Title of Work | Week's Activities | Assessment (end of unit) |
|---|---|---|---|
| | Course Guide | | |
| **Module 1:** | **INTRODUCTION TO ISLAMIC FINANCIAL SYSTEM** | | |
| 1 | Overview of Islamic Financial System | **Week 1** | **Assignment 1** |
| 2 | Growth Drivers of Islamic Finance | **Week 2** | **Assignment 2** |
| 3 | Fundamental Principles of Islamic Finance | **Week 3** | **Assignment 3** |
| 4 | Models of Islamic Finance | **Week 3** | |
| **MODULE 2** | **STRUCTURE OF ISLAMIC FINANCIAL SYSTEM** | | |
| 1 | Islamic Financial Markets | **Week 4** | **Assignment 1** |
| 2 | Islamic Financial Institutions | **Week 5 & 6** | **Assignment 2** |
| 3 | Islamic financial Instruments | **Week 7** | **Assignment 3** |
| **4** | Challengs Facing Islamic Finance Industry | **Week8** | |
| **MODULE 3** | **REGULATORY FRAMEWORK OF ISLAMIC FINANCIAL SYSTEM** | | |
| 1 | Rationale for Regulations of Islamic | **Week 9** | |

| | Finance | | |
|---|---|---|---|
| **2** | Regulatory and Supervisory authorities for Islamic Finance | **Week 10 & 11** | **Assignments 1 & 2** |
| **3** | International Standard-Setting organizations for Islamic finance | **Week 12** | **Assignment 3** |
| | Examination | **Weeks 13 & 14** | |
| | | | |

**How to Get the Most from the Course**

In distance learning the study units replace the university lecturer. This is one of the great advantages of distance learning; you can read and work through specially designed study materials at your own pace and at a time and place that suit you best.

Think of it as reading the lecture instead of listening to a lecturer. In the same way that a lecturer might set you some reading to do, the study units tell you when to read your books or other material, and when to embark on discussion with your colleagues. Just as a lecturer might give you an in-class exercise, your study units provides exercises for you to do at appropriate points.

Each of the study units follows a common format. The first item is an introduction to the subject matter of the unit and how a particular unit is integrated with the other units and the course as a whole. Next is a set of learning objectives. These objectives let you know what you should achieve by the time you have completed the unit.

You should use these objectives to guide your study. When you have finished the units, you must go back and check whether you have achieved the stated objectives. If you make a habit of doing this, you will significantly improve your chances of acquiring the knowledge, passing the course as well as getting a good grade.

The main body of the unit guides you through the required reading from other sources. This will usually be either from your set books or from a readings section. In particular, this course requires you to review conventional financial system-nature, institutions, operations, products and regulations. You will be directed when you need to embark on discussion and guided through the tasks you must do.

In any event, most of the critical thinking skills you will develop during studying are applicable in normal working practice, so it is important that you encounter them during your studies.

Self-assessments are interspersed throughout the units, and answers are given at the ends of the units. Working through these tests will help you to achieve the objectives of the

units and prepare you for the assignments and the examination. You should do each self-assessment exercises as you come to it in the study unit..

The following is a practical strategy for working through the course. If you run into any trouble, consult your tutor. Remember that your tutor's job is to help you. When you need help, don't hesitate to call and ask your tutor to provide it.

1. Read this Course Guide thoroughly.
2. Organize a study schedule. Refer to the `Course overview' for more details. Note the time you are expected to spend on each unit and how the assignments relate to the units. Important information, e.g. details of your tutorials, and the date of the first day of the semester is available from study centre. You need to gather together all this information in one place, such as your dairy or a wall calendar. Whatever method you choose to use, you should decide on and write in your own dates for working breach unit.
3. Once you have created your own study schedule, do everything you can to stick to it. The major reason that students fail is that they get behind with their course work. If you get into difficulties with your schedule, please let your tutor know before it is too late for help.
4. Turn to Unit 1 and read the introduction and the objectives for the unit.
5. Assemble the study materials. Information about what you need for a unit is given in the `Overview' at the beginning of each unit. You will also need both the study unit you are working on and one of your set books on your desk at the same time.
6. Work through the unit. The content of the unit itself has been arranged to provide a sequence for you to follow. As you work through the unit you will be instructed to read sections from your set books or other articles. Use the unit to guide your reading.
7. Up-to-date course information will be continuously delivered to you at the study centre.
8. Work before the relevant due date (about 4 weeks before due dates), get the Assignment File for the next required assignment. Keep in mind that you will learn a lot by doing the assignments carefully. They have been designed to help you meet the objectives of the course and, therefore, will help you pass the exam. Submit all assignments no later than the due date.
9. Review the objectives for each study unit to confirm that you have achieved them. If you feel unsure about any of the objectives, review the study material or consult your tutor.
10. When you are confident that you have achieved a unit's objectives, you can then start on the next unit. Proceed unit by unit through the course and try to pace your study so that you keep yourself on schedule.
11. When you have submitted an assignment to your tutor for marking do not wait for it return `before starting on the next units. Keep to your schedule. When the assignment is returned, pay particular attention to your tutor's comments, both on

the tutor-marked assignment form and also written on the assignment. Consult your tutor as soon as possible if you have any questions or problems.

12. After completing the last unit, review the course and prepare yourself for the final examination. Check that you have achieved the unit objectives (listed at the beginning of each unit) and the course objectives (listed in this Course Guide).

**Tutors and Tutorials**

There are some hours of tutorials (2-hours sessions) provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the name and phone number of your tutor, as soon as you are allocated a tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulty you might encounter, and provide assistance to you during the course. You must mail your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible.

Do not hesitate to contact your tutor by telephone, e-mail, or discussion board if you need help. The following might be circumstances in which you would find help necessary. Contact your tutor if.

- You do not understand any part of the study units or the assigned readings
- You have difficulty with the self-assessment exercises
- You have a question or problem with an assignment, with your tutor's comments on an assignment or with the grading of an assignment.

You should try your best to attend the tutorials. This is the only chance to have face to face contact with your tutor and to ask questions which are answered instantly. You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participating in discussions actively.

**Summary**

The course, Islamic financial system (ECO728), exposes you to the understanding of theory and practice of Islamic financial system, Islamic financial products and their Shari'ah rulings in transaction. It also gives you an insight into the Islamic financial institutions and financial markets and their roles as intermediary institutions in Islamic finance. Thereafter it shall enlighten you on the distinguishing features of Islamic financial system with that of the conventional finance. Finally, the regulatory framework of Islamic finance will be discussed, international institutions that serve as standard setting bodies for Islamic finance are discussed.

On successful completion of the course, you would have acquired critical knowledge for efficient and effective discussion on the course. However, to gain a lot from the course please try to apply what you have learnt in the course to term papers writing, assignments, tests and during final examination. We wish you success with the course and hope that you will find it interesting.

## MODULE 1: INTRODUCTION TO ISLAMIC FINANCIAL SYSTEM

**Content**

UNIT ONE: **Overview of Islamic Financial System**

**UNIT TWO: Growth Drivers of Islamic Finance**

**UNIT THREE: Fundamental Principles of Islamic Finance**

**UNIT FOUR: Models of Islamic Finance**

### UNIT ONE: Overview of Islamic Financial System

**1.0 Introduction**
**2.0 Objectives**
**3.0 Main Content**
- **3.1 Conceptual Background**
- **3.2 Shari 'ah Framework for Islamic Finance**
- **3.3 Evolution of Islamic Finance Industry**
- **3.4 Key Instruments of Islamic Finance**

**4.0 Summary and conclusion**
**5.0 Self-assessment Questions**
**6.0 References/Further Readings**

#### 1.0 Introduction

We will begin our discussion by introducing the course in terms of its meaning and some key concepts of Islamic finance. This unit gives an overview on the nature/institutions, and evolution of Islamic finance industry and its guiding framework i.e Shari'ah as well as the key instruments of financial transaction.

#### 2.0 Objectives

At the end of this unit, students should be able to learn and understand the following:

- The nature of the Islamic finance industry
- Overview of its development
- Shari'ah framework for Islamic financial system

## 3.0 Main Content

### 3.1 Conceptual Background

With the emergence of the decolonization of Islamic countries in the second half of the 20th century, Muslim thinkers and philosophers attempted to formalize Islamic financial system. Also, they aim to criticize capitalism and its banking principle as *Haram* (forbidden). Since then, Muslim leaders has placed emphasis on Islamic economic system. This is because they believed one important way to set their country free from the western dominance was to establish a sharia-based economy.

The emergence of Islamic finance as a new phenomenon within the long established and deep-rooted conventional finance for the past four decades is of particular significance to Muslims whose lives are governed by the rules and values, prescribed by Islamic law and principles popularly known as Shari'ah. The monopoly status enjoyed by the conventional financial system of Islamic banking and finance which hitherto, remains the only medium of financial transactions, with impunity nurtures and survives on interest, hatches uncertainty and increased speculation all for profit maximization. The system was blamed for incessant economic turmoil in the past and the ongoing financial crisis in the Western European countries, which had its roots in the United States mortgage crisis in the late 2007.

The Islamic system of banking and finance is coveted for its prohibition of interest, despising uncertainty and denouncing speculation. With emphasis on resource mobilization for active partnership with entrepreneurs and real sector operators of the economy, the Islamic system proved to be capable of stimulating real growth – non inflationary growth, by way of forging mutual cooperation in risk taking and profit and loss sharing. In addition, Islamic financial system is admired for fostering economic development, social progress and distributive justice, which is why, unlike the conventional system, it is more concerned with the viability of business proposal and, equally its profitability, as against the size of the collateral, business cash flow and rate of return, that is, interest rate. Aliyu S.R (2012).

It is estimated that there are over five hundred and fifty (550) financial institutions worldwide, with assets in excess of one trillion US Dollars which adhere to Islamic finance principles, operating in seventy five (75) countries encompassing most of the Muslim world, along with Europe, North America and various offshore locations. ISRA (2011)

A financial system is a complex set of financial institutions and markets that bring together lenders and borrowers consisting of banks, insurance companies, mutual funds and other finance companies. The main objective of a financial system therefore is to mobilize large amounts of relatively small saving and pool them together to channel them for productive investments in the economy. The financial system consists of financial markets and institutions actively engaged in the channeling of investible funds from surplus fund units (SFUs) to deficit fund units (DFUs). The SFUs are those with current

incomes in excess of spending plans, whereas the DFUs are those with spending plans in excess of the current incomes. However, the basic function of a financial system whether conventional or Islamic is intermediation (resource mobilization and resource allocation) to finance productive investments. In addition to facilitating the flow of funds between the SFUs and DFUs, financial institutions also develop instruments, techniques and products that meet the needs of both lenders and borrowers.

Islamic finance is founded on Shari'ah principles which express an explicit intention to meet the financial needs of participants with integrity and in a manner that is just, fair, trustworthy and honest, while ensuring a more equitable wealth distribution. (MIFC,Primer to Islamic finance,2007 p.4). This however, suggests that Islamic financial markets and institutions deal with resource allocation, management, acquisition and investment. It also inevitably deals with the fundamental issue in finance which is risk transformation and management. Therefore, Islamic finance is expected to essentially function similarly or at least produce the same economic effect to that of its conventional counterpart.

The Islamic financial system is not limited to banking but covers insurance, capital formation, capital markets, and all types of financial intermediation and suggests that moral and ethical aspects in the regulatory framework are also necessary in addition to prudent and sound controls. Indeed, Islamic finance is built upon some distinctive and unique characteristics which are based upon certain principles underlined by Shari'ah. Some of the prominent elements constituting parts of its characteristics include: the prohibition of Riba or pre-determined rate of interest, the prevention of gharar (ambiguity) in contracts, the prohibition of gambling (maysir), the prohibition of conducting economic or investment activities which are ethically and socially unacceptable albeit profitable (e.g, pornography, gambling, alcohol and prostitution), the prohibition of monopoly, the introduction of a religious levy or alms-giving(zakat), and co-operation for the benefit of society and development of all religiously legitimized (halal) aspects of business, trade and investment. ISRA (2010).

This series of religious derivation principles must be applied in the managerial processes of Islamic finance institutions and in their operating instruments for pursuing sustainable results, i.e., achieving economic performance in respect to their own religious principles, directed at assisting the achievement of social justice, understood as the fair distribution of wealth in the society, and safeguarding the interests of the parties in the context in which the finance institutions operate (socio-environmental performance). It is therefore a model characterized by the promotion of economic activities that must be in line with both the religious principles of Islam and the conventional laws in force. Consequently, when talking of Islamic finance in general and of Islamic banks in particular, reference is made to an integral and non-exclusive part of a complex economic system, i.e., the Islamic economic system, the principles and characteristics of which derive from the

sharia. These principles require the Muslim believer to undertake economic activities that respect the precepts of Islam, defined in modern terms as sharia compliant activities and, therefore, to eschew investments and entrepreneurial activities against the values of Islam.

The objective of Islamic finance transactions as summarized from the article written by Zamir Iqbal in World Bank publication (1997) are as follows:

- To establish the Shari'ah principles of equity and justice
- Should be free from unjust enrichment
- Must be based on true consent of all parties
- Must be an integral part of a real trade or economic activity such as sale, lease manufacture or partnership.

### 3.2 Shari 'ah Framework for Islamic Finance

Shari'ah literally means "the road to the watering place" or "the straight path to be followed". The Qur'an has used the word Shari'ah with this meaning in the following verse:

"Then We have put you (O Muhammad,(peace be upon him) on a plain way of (our) commandment. So follow you that (Islamic monotheism and its laws) and follow not the desires of those who know not."(Al-Qur'an, 45:18).

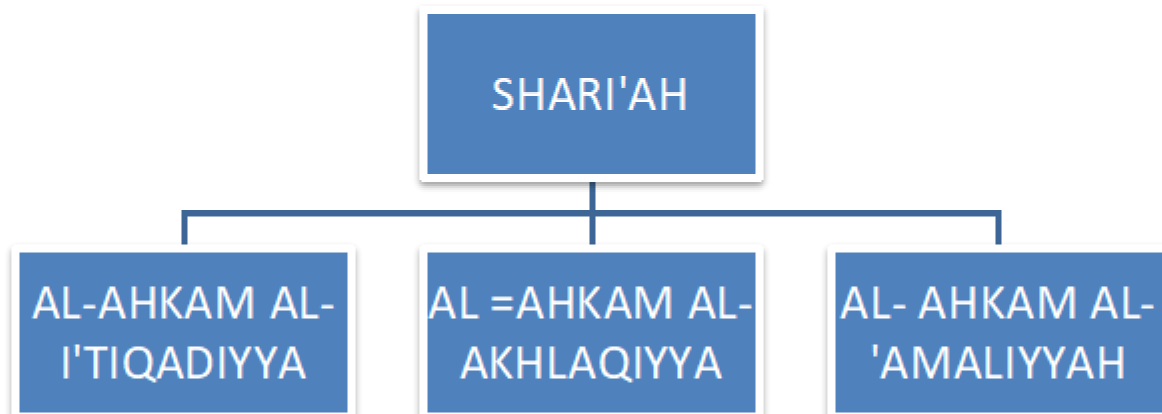
As a technical term, however, the word Shari'ah was defined by Al-Qurtubi as the canon law of Islam, all the different commandments of Allah (Subhanahu wa ta'ala) to mankind. Some scholars defined this word as the injunctions revealed to the prophets of Allah (s.w.t) related to law or belief. In addition to the above definition, some scholars confined Shari'ah to its linguistic meaning by saying that this word means, "following strictly the injunctions of Allah (s.w.t) or the way of Islam (din)." Mohammad A (2008)

A comprehensive definition of the word Shari'ah can be deduced from the different definitions given above as follows: It is the sum of Islamic teaching and system, which as revealed to Prophet Muhammad (p.b.u.h), recorded in the Qur'an as well as deducible from the prophet's divinely-guided lifestyle called Sunnah. Some scholars view that all different commandments of Allah (s.w.t) to mankind are part of Shari'ah. Each one of such commandments is called hukm (plural ahkam). The law of Allah (s.w.t) and its inner meaning is not easy to grasp and shari'ah regulates all human actions. This is why it is not "law" in the modern sense as it contains a comprehensive set of dogmas, legal and ethical doctrines. It is basically a doctrine of duties, a code obligation. For this reason, legal considerations and individual rights have a minor place in it. Above all, the tendency towards a religious evaluation of all the affairs of life is absolute. Mohammad (2008)

In the context of Islamic finance, the word Shari'ah is regularly being used to denote the compliant aspect of Islamic financial products and services. Of late, there are two key words that are commonly used by the Islamic finance industry; namely:"Shari'ah compliant" and Shari'ah-based" products and services. Shari'ah-compliant products refer to products which have their origin from the conventional market and are "Islamized" by modifying it to suit the Shari'ah requirements. This is usually done by inserting certain contracts and peripherals in the structure in order to make it Shari'ah-compliant. A classic example of such a structure is in the ijarah (leasing) contract coupled with the option of buying the asset at the end of the contract which is also known as al-ijarah thumma al-bay' or ijarah muntahiyah bittamlik. This contract is similar to the hire purchase contract in conventional products. On the other hand, Shari'ah based products refer to products which do not originate from conventional practice, examples of such products are physical assets or tangible goods. The important criteria in determining the acceptability of a product from the Shari'ah point of view depends on its compliance with the rules and regulations of Shari'ah. As long as the product is in compliance with all the requirement of Shari'ah, it will be deemed acceptable. ISRA (2011)

### 3.2.1 COMPONENTS OF *SHARI'AH*

The *Shari'ah* which contains all the different commandments of Allah (swt) to mankind ,can be divided into three fields. The first *al-ahkam al-I'tiqadiyyah (the sanctions relating to beliefs)*such as the belief in Allah and the day of judgement. The second is *al-ahkam al-akhlaqiyyah (sanctions relating to moral ethics)* such as the injunction to tell the truth, be sincere ,be honest ,etc. The last category is *al-ahkam al-amaliyyah (*sanctions relating to the sayings and doings of the individual and his relations with others) which is also called *fiqh.* Mohammad (2008)



### 3.2.1 FIQH CONCEPT

Fiqh is the name given to the whole science of jurisprudence because it implies the exercise of intelligence in deciding a point of law in the absence of a binding text of the QURAN or SUNNNAH. Fiqh is derived from the root word *faqaha* which literally means comprehension or true understanding .The Qur'an has used this word with the above meaning in several occasions. The verse stated below exemplifies, among others, instances of its use in that respect.

"*And make loose the knot (the defect) from my tongue, that they understand my speech"*

*(*AL-QURAN, 20:27-28)

Fiqh or Islamic law is a component of Shari'ah and it has a close relationship with Usul-al- fiqh which comprises the principles of Islamic law. Usul-al-fiqh has its own tools in deriving the rulings of fiqh. All the sources of fiqh, be it primary sources or secondary sources are the tools in deriving the rulings of fiqh.

Abu Hanifah, the founder of Hanafi school of Islamic law (d.767CE), defines fiqh as " the knowledge of what is for a man's self and what is not man's self." However Al – Ghazali (d.505 AH) confined the word fiqh as the science of the rules of law. Al-Amidi gave a broader definition of fiqh as "the science of understanding the legal obligations derived from its sources ( Qur 'an, Sunnah and other sources of Islamic law)." Akram M (2006).

However, majority of Islamic authorities define it in terms of its four basic sources as follows:

"Fiqh, or the science of Islamic law, is the knowledge of one's rights and obligations derived from the Qur'an or Sunnah of the prophet (p.b.u.h), or the consesus of opinions among the learned (Ijma'). Or analogical reasoning (qiyas)." ISRA, (2011)

### 3.2.3 Sources of Shari'ah

The classic definition of fiqh has been premised on the following famous tradition of Mu'az Ibn Jabal who reported that the Prophet (PBUH), was reported to have sent Mu'az bn Jabal as the Governor to Yemen and also appointed him as a judge. Before sending him, the prophet (pbuh) asked him: "According to what will you judge if a problem is brought to you?" He replied,"according to scriptures of Allah (s.w.t) "And if you did not find anything in it? He replied "According to the *Sunnah* of the messenger of Allah," and if you don't find anything in it? The prophet (pbuh) asked him. Then I shall strive to interpret with the exertion of my reasoning ," Muaz replied . And there upon the prophet said : "Praise be to Allah who has favoured the messenger of His Messenger

with what His Messenger is willing to approve of".(*sunnan Abu Dawud,hadith no.359 in mohammad 2008)*. This Hadith gives expression to what actually must have taken place during the time of the prophet. It explains the Islamic perception of the methods of deriving legal actions solutions which serve the basis of the sources of the Shar'ah.

### 3.2.3 Classification of sources of Shari'ah

The scholars have classified the sources of Shari'ah into various categories .One of these classifications is based on the origin of the sources. This classification views Qur'an and Sunnah as the primary sources while other sources based on reasoning are called secondary sources. The Quran and Sunnah are considered as the sources that originate from the text of revelation which is called textual sources or al-nass. Other sources based on the power of reasoning are called non-textual sources or al-ra'y. There are some sources about which scholars of Islamic law are in agreement in their utilization as valid sources. These include the QURAN, SUNNAH, IJMAH and QIYAS. Indeed, no scholars have challenged the authority of these four sources over other subordinate sources. The other category is the secondary source of Islamic law in which the scholars differs in their utilization as relevant sources and as base in deducing the rulings of Islamic law. .Some of the scholars consider them as sources while others do not .These sources are juristic preference (istihsan), presumption of continuity (istishab) ,custom(urf),consideration of public interest (masalahah al-mursalah), blocking the means (sad al-dhara'i); and the practice of the prophet of Madinah(amal ahl al-Madinah). ISRA(2011).

## 3.3 Evolution of Islamic Finance Industry

Although Islamic finance has been considered as niche finance, worth more or less 1% of the world's finance in the last few decades, it has proven to be innovative, its recent and continuous growth—by 2 trillion USD in 2015 according to the ICD—Thomson Reuters Islamic Finance Development Report 2016—estimated between 10% and 20% per year in different economic and financial segments in many parts of the world. It was only in the twentieth century, and specifically in the Seventies, that the first Islamic banks were born, a phenomenon that was the starting point of the establishment of the Islamic finance industry in its modern meaning ( Harrison T,2016, Iqbal Z, 2011) and aroused the interest of scholars, both Muslim and non-Muslim (Narayan et al 2017). Attention to Islamic Finance and its development is not limited to Muslim countries but also involved non-Muslim countries ( Iqbal, Z, : http://dx.doi.org/10.1596/978-0-8213-9953-8 ) at the time of the financial crisis of 2008, and it has been classified as an alternative, ethical, remunerative and safe finance (. Ahmed, A 2010)].

The Islamic finance industry is an industry that offers financial intermediation services based on compliance with the Islamic law (Shari'ah). Its broad segments are four: Islamic banking, Islamic funds, the sukuk market and Takaful or Islamic insurance. The industry has evolved to become an essential part of the international financial system

witnessing tremendous growth both in terms of assets and .geographical spread. Its global assets have hit the USD 1 trillion by the end of 2011, and growing worldwide at a strong rate of 15-20% (See the Banker of November 2011).These assets are expected to reach USD 1.6 trillion by 2012 according to the Global Islamic Finance Forum 2012 estimates. Currently, according to the Islamic Finance Development 2019 Report, the Islamic finance industry's total assets grew to $US2.5 trillion in 2018 from $US2.4 in 2017, a rise of 3 percent. Islamic banking contributes over 70 percent of the assets.

It has achieved wide geographic presence outside the Middle East and North Africa. It is offered in Europe in the UK (which is the 8th country in the world in terms of Islamic finance assets), Switzerland, Luxembourg, Germany and France.

In Africa, there are Islamic banks in Kenya,Tanzania,Uganda,Botswana,SouthAfrica,Mauritius,Senegal,Gambia,Mauritania,Benin,Niger etc. In Asia, outside the Muslim majority countries it is offered in Singapore, Thailand Hong Kong, Sri-lanka, Japan and South Korea. It is also offered in the US and Australia.

The number of Islamic financial institutions worldwide has risen from one institution in 1962 to over 400 institutions as of 2009, operating in over 75 countries, with Bahrain, Malaysia and UK being global hubs. Bashir (2015).

Major western international financial institutions have windows or subsidiaries of Islamic financial institutions. These include HSBC, Citigroup, Standard Chartered, BNP Paribas, Deutsche Bank, Lloyds Banking Group, Tokyo Marine Insurance, Swiss Re etc.

Islamic banking and finance has become a discipline of study in which degrees both undergraduate and postgraduate are now being offered in universities and institutions of higher learning all over the world, including many western institutions, such as Harvard Islamic Finance Forum, University of Reading, Durham University, Loughborough University, Luxembourg University; and courses in Islamic finance are being offered by professional bodies such as the UK Chartered Institute for Securities and Investment(CISI). Bashir (2011)

The tremendous global appeal and phenomenal growth of Islamic finance over the last four decades is due largely to its value propositions and features, which promote ethically responsible investing as well as real and inclusive economic growth and development.

### 3.3.1 Historical Development of the Islamic Finance Industry

Compliance to the principles of the shari'ah is the central element of Islamic finance and the most significant and far-reaching of these principles is the observance of the prohibition of dealing with interest in commercial transactions. This prohibition is

common to the religions of Judaism, Christianity and Islam, and the Scriptures of these three religions are awash with clear rulings on it. Against this background of scriptural rulings, the prohibition to deal in interest was strictly observed on economic and commercial dealings in the history of these three religious communities.(see:Jared Rubin,Bills of exchange, Interest Bans and Impersonal Exchange in Islam and Christianity).As a result of these restrictions, alternative forms of financial intermediation were introduced and widely practiced especially in Islamic and Jewish communities of medieval times to finance economic and commercial activities on a non-interest basis. The most famous instruments that had wide application were the partnership-based contracts known in historical circles as the commendas or mudarabah/qirad in Islamic law (see Abraham Udovitch, partnership and profits in Medieval Islam and see the Cairo Geniza on Jewish records of these transactions). Bashir, A (2015)

It was not until modern times that Islamic banking was developed to serve the purpose of financial intermediation permissible under the Divine law, in the way that the partnership-based contracts of medieval times served the communities observing the Divine law.

The land mark events that marked the evolution of modern Islamic finance generally started in the 1890s, when the Barclays Bank opened its Cairo branch to process the financial transactions related to the construction of the Suez Canal. This is understood to be the first commercial bank established in the Muslim world. As soon as the bank's branch was opened, Islamic scholars initiated the critique of bank interest as the riba prohibited in the Qur'an and Sunnah. Between 1900 and 1930, the critique had spread to other Arab regimes and to the Indian sub-continent, with a majority of scholars subscribing to the position that interest in all its forms constitutes the prohibited riba. Between 1930 and 1950, Islamic economists had initiated the first critique of interest from the Islamic economics perspective and attempted to outline Shar'ah-compliant alternatives to interest-based financing in the form of partnerships both active and silent.

By 1960s, practical models of finance based on Islamic principles began in Egypt and Malaysia. The land mark events included the rise and fall of Mitghamr (Egypt) Savings Associations during the 1961-1964 period and the establishment of Malaysia's Tabung Hajj in 1962, which was a pilgrimage savings scheme that invested funds mobilized from intending pilgrims in ventures that provided returns to the investors who were partners in the venture providing capital with the institution being active partner or entrepreneur. Tabung Hajj flourished and became the oldest financial institution in the modern times.

Islamic banks emerged with the establishment of Dubai Islamic bank and Islamic Development Bank in Jeddah, Saudi Arabia in 1975. Also in 1975, objections to conventional insurance from Shari'ah perspective became pronounced. Laying the

ground for an alternative structure called takaful that was similar in a number of ways to mutual insurance institutions famous in United Kingdom (UK). The first takaful company was established in 1979.

In 1980s, more Islamic finance banking institutions were established and significant attention to the nascent industry developed in the West around this time with the IMF publishing working papers on Islamic banking, publications and postgraduate research were on the increase. Islamic mutual funds and other non-banking financial institutions appeared by the middle of the decade.

In the 1990s, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as the first standard setting organization for the industry was established and started issuing standards right from its inception. Interest in Islamic finance grew in the west with the establishment of various institutions of learning offering courses on Islamic finance. Large conventional international banks like Citibank, Standard Chartered and HSBC started offering Islamic banking services as Islamic windows.

Between 2000 and 2006, Sovereign and corporate sukuk, which are asset-backed or asset-based investment certificates emerged as alternatives to conventional bonds and started increasing rapidly in volume. International Islamic financial infrastructure institutions such as the Islamic Financial Services Board (IFSB), International Islamic Financial market (IIFM), General Council for Islamic Banks and Financial Institutions (CIBAFI), (Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI), and other commercial support institutions such as the International Islamic Rating Agency (IIRA) and Liquidity Management Centre (LMC), were established. Bashir (2011)

Between 2007 and 2010, more non- Muslim majority countries introduce Islamic finance such as Luxembourg, Singapore, China, Botswana and Kenya. The International Islamic Finance Forum was formed to serve as a platform for the deliberation of issues relevant to the stability of the Islamic financial system and International Islamic Liquidity Management Corporation (IILM) was also formed to offer high quality liquidity instruments to address the liquidity management challenges of Islamic financial institutions. Narayan (2017)

These events have led to the emergence of a vibrant and fast growing financial services industry and they give weight to the financial viability of the industry and the positive impact it portends on its stakeholders.

### 3.4 Key Islamic Finance Instruments

Central to Islamic finance is the fact that money itself has no intrinsic value. As a matter of faith, a Muslim cannot lend money to, or receive money from someone and expect to

benefit. This means that interest is not allowed and making money from money is forbidden. Money must be used in a productive way, by which wealth can only be generated through legitimate trade and investment in assets. The principal means of Islamic finance are based on trading. Any gains relating to the trading are shared between the party providing the capital and the party providing the expertise. As a result, the Islamic banks have developed six main Islamic financing techniques, which are: Mudaraba, Musharaka, Murabaha, Ijara, Istisna and Salam (Karim, 2002).

***1. Mudarabah (Trust financing):*** Contracts are profit-sharing agreements, in which a bank provides the entire capital needed to finance a project, and the customer provides the expertise, management and labour. The profits from the project are shared by both parties on a pre-agreed (fixed ratio) basis, but in the cases of losses, the total loss is borne by the bank (Schaik, 2001).

***2. Musharakah (Partnership):*** Contracts are similar to joint venture agreements, in which a bank and an entrepreneur jointly contribute capital and manage a business project. Any profit-and-loss from the project is shared in a pre-determined manner. The joint venture is an independent legal entity, and the bank may terminate the joint venture gradually after a certain period or upon the fulfillment of a certain condition (Alam, 2003).

***3. Murabahah (Cost-plus mark-up):*** Murabaha financing is based on a mark-up (or cost plus) principle, in which a bank is authorized to buy goods for a customer and resell them to the customer at a pre-determined price that includes the original cost plus a negotiated profit margin. This contract is typically used in working capital and trade financing (Suleiman, 2000).

***4. Ijara (Sale and leaseback):*** A bank buys an asset for a customer and then leases it to the customer for a certain period at a fixed rental charge. Shariah (Islamic law) permits rental charges on property services, on the precondition that the lessor (bank) retain the risk of asset ownership.

***5. Salam (Future delivery):*** Salam is structured based on a forward sale concept. This method allows an entrepreneur to sell some specified goods to a bank at a price determined and paid at the time of contract, with delivery of the goods in the future.

***6. Istisna (Construction / manufacturing):*** Istisna contracts are based on the concept of commissioned or contract manufacturing, whereby a party undertakes to produce a specific good for future delivery at a pre-determined price. It can be used in the financing of manufactured goods, construction and infrastructure projects. All above instruments are based on the principle of riba (interest) prohibition, and all seek to maintain Islamic business ethics. Karim (2002)

Other financing techniques employed in financial transactions based on the nature and demand of the products by the growing public includes the following:

**Musawamah** Is the negotiation of a selling price between two parties without reference by the seller to either costs or asking price. While the seller may or may not have full knowledge of the cost of the item being negotiated they are under no obligation to reveal these costs as part of the negotiation process. This difference in obligation by the seller is the key distinction between Murabahah and Musawamah.

**Bai'al inah (sale and buy- back agreement)**
Is a financing facility with the underlying buy and sell transactions between the financier and the customer. The financier buys an asset from the customer on spot basis. The price paid by the financier constitutes the disbursement under the facility. Subsequently the asset is sold to the customer on a deferred- payment basis and the price is payable in installments. The second sale serves to create the obligation on the part of the customer under the facility.

**Bai'bitaman ajil (deferred payment sale)** it refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties. Like Bai'al inah, this concept is also used under an Islamic financing facility. Interest payment can be avoided as the customer is paying the sale price which is not the same as interest charged on a loan.

**Bai'muajjal (Credit sale)** it means a credit sale. It is a financing technique adopted by Islamic banks that takes the form of murabahah muajjal. It is a contract in which the bank earns a profit margin on the purchase price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in installments. Bai'muajjal is also called a deferred-payment sale.

**Hibah (Gift)** this is a token given voluntarily by a debtor to a debater in return for a loan. Hibah usually arises in practice when Islamic banks voluntarily pay their customers a ―gift‖ on saving account balances, representing a portion of the profit made by using those savings account balances in other activities. This is a voluntary payment made (or not made) at the bank's discretion, and cannot be guaranteed.

**Ju'ala (Service charge)** a party pays another a specified amount of money as a fee for rendering a specific service in accordance with the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.

**Kafala (Guarantee)** it is a pledge given to a creditor that the debtor will pay the debt, fine or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.

**Tawarruq** is a financing hybrid that aims at providing cash or personal finance to a customer. Similar to "buy back," it adds certain goods or assets between the provision of cash to the customer and the customer repayment of a larger sum in the future. *Tawarruq* consists of a *murabahah* to the purchase orderer plus another agency contract in which the customer authorizes the bank, on behalf of the customer, to sell the same goods purchased on *Murabahah* for cash and hand the money to the customer. *Tawarruq* is exercised on local goods, such as cars or common stocks, or on international commodities in the international exchange markets. In the latter case, a number of spot commodity contracts will be used depending on the amount of financing. Mumtaz H. et al (2015)

## 4.0 Summary and Conclusion

Discussions in this unit were focused on the introduction of the Islamic financial system as a nascent industry and its development in terms of assets and geographical spread, which paves the way for its integration into the international financial system as an alternative to conventional financial system. Shari'ah framework for Islamic finance was discussed to aid understanding of its applicability to the Islamic financial system which gives the system its character and shape thereby serving the basic foundation of its principles and operations.

## 5.0 Self-Assessment Exercise

Discuss clearly the following**:**

A. What you understand by the term Islamic Financial system
B. Advantages of Islamic financial system over the conventional system.
C. Distinguish between fiqh and Usul-al-fiqh as Shari;ah component

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## UNIT TWO: GROWTH DRIVERS OF ISLAMIC FINANCE


1.0 Introduction
2.0 Objectives
3.0 Main Content

3.1 Contributive factors to the development of Islamic Finance Globally

4.0 Self-Assessment Exercise
5.0 Summary and conclusion
6.0 References


### 1.0 Introduction

There are various reasons that led to the development of Islamic finance as global financial system. This unit intends to give some of these contributive factors to the growth of Islamic finance around the globe.

### 2.0 Objectives

The aim of this unit is to enhance understanding of the students on the following;

- The major factors that led to the growth of Islamic finance globally
- To show the growth potentials of the Islamic finance industry accrued to different financial segments.
- To appraise the global integration of the Islamic financial system (IFS)

### 3.0 Main Content

### 3.1 Contributive factors to the development of Islamic Finance Globally

Islamic finance has become an increasingly integral part of the global financial system. Since the developments of the modern Islamic finance in the 1960s, the IFIs has evolved from a ―fringe industry‖ that catered to the specific banking requirements of the Muslim community to a global industry encompassing banking, insurance and capital market. The Islamic financial landscape has now been dramatically transformed with more diverse players with an extensive range of financial products and services. The rapid expansion of Islamic finance as a viable form of financial intermediation reflects its ability to meet the changing pattern of demand by consumers and businesses, its competitiveness and its ability to withstand the more challenging environment. This has encouraged strong interest from conventional global players from the developed economies that have increased their participation in Islamic financial markets. More recently, there have been increased initiatives to acquire strategic stakes in Islamic financial institutions in different parts of the world. With increased liberalization, the Islamic financial system has become more diversified and the Islamic financial markets have deepened. As a result, Islamic finance has now emerged as among the fastest growing segments in the international financial services industry. Ahmad M (2012)

A recent report (Thomson Reuters, 2013) identifies four key Islamic market-based drivers of growth of Islamic finance: demographic (large and fast growing young population), economics (growing economies some of which have reached the emerging market status), and Islamic values (values driving business practices), and growing trade among Organization of Islamic Countries.

Four additional global environment-based drivers are also shaping the industry. These include: -- Participation of multinationals in the Islamic economy, seeking growth markets by developed countries.

- Increasing focus on business ethics and social responsibility, and
- The global revolution in communication technology.

In addition, its rapid development is particularly evident from various dimensions as follows:

- The growing need of Muslims for a *Shari'ah*-compliant financial system seems to drive the growth of Islamic finance. Early Muslims were not familiar with banking operations, and the concept of a bank as a modern institution is new to Islamic societies. Initially, many Muslims did not even understand the extent and importance of banks in their everyday lives, even if living in non-Islamic countries. However, they realized that interest payments from conventional banking were at odds with the prohibited *riba*, they naturally looked for alternative modes of financing. Early initiatives in the 1960s led to the establishment of Islamic financial institutions in Egypt, India, Malaysia, Pakistan, Saudi Arabia, and later in Iran and Sudan, where Islamic finance was adopted as the only financial system countrywide.
- Another dimension of the industry's growth is driven, naturally, by economic growth in the MENA (Middle East and North Africa) region. Over the past decade, the MENA region has witnessed a solid growth path, which in turn has helped the Islamic finance industry, particularly banking assets. The average real GDP growth in the MENA region has been about 4 percent, with the highest growth rate of 11 percent in Qatar and 5.2 percent in Saudi Arabia. Although some argue that rising oil revenues and the real estate boom in some GCC (Gulf Cooperation Council) countries may have also helped the industry to grow, pointedly, real non-oil GDP of GCC countries has expanded, on average, by only 3 percent, while the Islamic finance industry has seen double-digit growth in the past 10 years. Many countries including from Europe, Singapore, and the United States are joining the band wagon to capture capital flows from the Middle East (Hesse, Jobst, and Sole, 2008).

- Political support, better regulatory framework, and a level playing field may have also helped spur the industry's growth, especially in Indonesia, Malaysia, and the MENA region. However, the industry in the MENA region could grow even faster with improvements in regulatory and

supervisory frameworks. Also, a level playing field is a prerequisite for sustainable penetration of the industry.

- From being concentrated in Muslim populated regions, Islamic finance is now viewed as a competitive form of financial intermediation that has drawn significant participation by non-Muslims. For borrowers, it is seen as an alternative means of financing. For investors, it is seen as a new asset class. Islamic finance has thus witnessed exceptional growth, not only in the Muslim world, where its growth is premised on religious and business considerations, but also across the Western world where the growth is driven by commercial and business considerations.

- The nature of the business of Islamic finance has also evolved, from being mainly focused on retail and trade financing to the financing of other commercial business activities. With the emergence of more diverse Islamic financial institutions and the development of the Islamic financial markets, the scope of Islamic finance business has been expanded to include private equity, project finance, the origination and issuance of sukuk, and fund, asset and wealth management activities.

- The importance of the IFS comes to the global financial system only after the global financial crisis occurred in 2008. It has been reported that the continuing volatility in bond and equity markets, combined with the uncertainty surrounding the Euro Zone, has opened up the Islamic finance industry to a new segment of potential investors looking to diversify away from traditional investment. In recent years, growth in Islamic financial assets has generally outperformed conventional financial instruments, particularly following the onset of the financial crisis that has been gripping the world since 2008. The performance and relative stability of Islamic financial institutions during the financial crisis that hit the world in 2008 stems from the distinctive features of the instruments they offer. Islamic finance emphasizes asset backing and the principle of risk sharing, prohibition of interest, ensuring a direct link between financial transactions and real sector activities. The return on savings and investment is closely linked (determined by the real sector, not the financial sector); giving Islamic finance modes a flexible adjustment mechanism in the case of unanticipated shocks. (Chapra, 2008)

**4.0 Self-Assessment Exercise**

Give and explain the major factors that contributed to the growth of Islamic finance across the globe.

## 5.0 Summary and Conclusion

In this unit, we have explained clearly the key factors that contributed to the growth and development of IFS across the globe. These drivers are largely attributed to growing concern of the Muslims to practice modes of financing in line with Shari'ah, growth of the wealth of Muslim nations and net wealth individuals especially among the GCC and MENA regions which allows penetration of capital to invest in Islamic finance industry, Market conditions and uncertainties that prevail over time and the ethical features of the system (IFS) paves the way for its integration into the global finance.

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**UNIT THREE: Fundamental Principles of Islamic Finance**

**1.0 Introduction**

**2.0 Objectives**

**3.0 Main content**

**3.1 Basic Principles of Islamic Finance**

## 1.0 Introduction

The basic framework for Islamic finance is a set of rules and laws, collectively referred to as Shari'ah, governing economic, social, political, and cultural aspects of Islamic societies. The Shari'ah originates from the rules dictated by the Qur'an and its practices, and explanations rendered (more commonly known as Sunnah) by the Prophet Muhammad (pbuh). Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the teachings in the Qur'an and Sunnah.

## 2.0 Objectives

Discussions in this unit will explain the basic principles of Islamic finance as provided by the Shari'ah rulings to acquaint the students with the following:

- Understanding of the guiding principles of Islamic finance operation
- The reasons behind certain prohibitions in Islamic finance transactions
- Enhance their knowledge of the Islamic finance dealings
-

## 3.0 Main Content

### 3.1 Fundamental Principles of Islamic Finance

The fundamental principles of an Islamic financial system can be summarized as follows:

#### 3.1.1 Prohibition of interest

***Prohibition of Riba (interest):*** Riba is an Arabic word for "growth" or "increase" and denotes the payment or receipt of interest for the use of money. The Qur'an expressly forbids riba, which includes any payment of interest (not only excessive interest) on monetary loans. The Quran states, "O You who believe! Fear Allah and give up what remains of your demand for usury, if you are indeed believers." Usury encompasses any payment of interest. Muslim scholars have interpreted riba to mean any fixed or

guaranteed interest payment on cash advances or on deposits (Mahmud, 2004).In prohibiting riba, Islam seeks to foster an environment based on fairness and justice. A loan with a fixed return to the lender, regardless of the outcome of the borrower's course of action is viewed as unfair. Riba is also believed to be exploitative and unproductive because it is considered to represent sure gain to the lender without any possibility of loss as well as a reward in return for no work. These factors are believed to lead, in turn, to inflation and unemployment and to stifle the social and infrastructural development of a nation. Dependence on interest prevents people from working to earn money, since the person with dollars can earn an extra dollar through interest, either in advance or at a later date, without working for it. The value of work will consequently be reduced in his estimation, and he will not bother to take the trouble of running a business or risking his money in trade or industry. This will lead to depriving people of benefits, and the business of the world cannot go on without industries, trade and commerce, building and construction, all of which need capital at risk. Further, permitting the taking of interest discourages people from doing well to one another, as is required by Islam. If interest is prohibited in a society, people will lend to each other with goodwill, expecting back no more than what they have loaned, while if interest is made permissible, the needy person will be required to pay back more on loans (than he has borrowed), weakening his feelings of great good will and friendliness toward the lender. (This is the moral aspect of the prohibition of interest). Finally, the lender is very likely to be wealthy and the borrower poor. If interest is allowed, the rich will exploit the poor, and this is against the spirit of mercy and charity, (This is the social aspect of the prohibition of interest). Thus, in a society in which interest is lawful, the strong benefits from the suffering of the weak.

As a result, the rich become richer and the poor become poorer, creating socio-economic classes in the society separated by wide gulfs. Naturally, this generates envy and hatred among the poor toward the rich, and contempt and callousness among the rich toward the poor. Conflicts arise, the socio-economic fabric is rent, revolutions are born, and social order is threatened (Warde, 2000). Recent history illustrates the dangers to the peace and stability of nations inherent in interest-based economies. Friedman (1969) has demonstrated that a zero nominal interest rate is a necessary condition for an optimal allowance of resources. Fixing a zero interest rate, traders will have no reason to substitute real resources for money, so more resources will be conducted to investments. Therefore, when fixing a positive price for money, traders would economize money for a fixed return and to reduce their transaction costs. It is demonstrated empirically that zero interest rate is both necessary and sufficient for efficient allocation in general equilibrium models (Wilson, 1979). Thus, Islam prohibits interest in the finance system to promote economic and social justice.

### 3.1.2 Risk and Return sharing

Shari'ah prohibits Muslims from earning income by charging interest but permits income generation through the sharing of risks and rewards between the parties to a transaction (no pain no gain strategy). This profit sharing mechanism is believed to encourage people to become partners and work together rather than to enter into a creditor–debtor relationship. Partnership promotes mutual responsibility for the outcome of the financed project, which is believed to increase the likelihood of success of the venture. A tangential aim of the partnership approach is to help increase the growth of successful projects, also provide stimulus to the economy. On their analysis Cihák and Hesse (2008), proved that Islamic financial system is financially stronger and less risky than conventional banks. In the conventional system, a depreciation of assets due to an exogenous shock downgrade the bank Equity capital, since its depositors have fixed value securities (the deposits), and which may lead to risks to cause the bankruptcy. In an Islamic system, the possessors of investment accounts don't have fixed value securities, in macroeconomic or bank-specific crises investment depositors automatically share the risk, which allows an adjustment of the liability, in case of asset reduction.

### 3.1.3 Prohibition of speculative behavior

Islamic finance prohibits transactions featuring speculation including extreme uncertainties, gambling, and risks. Therefore, transactions in Islamic finance should be backed by real assets.

Shariah prohibits financial transactions that involve Gharar, which is often translated as "deception," "excessive risk," or "excessive uncertainty". Gharar refers to any transaction of probable items whose existence or characteristics are not certain, due to lack of information, ignorance of essential elements in the transaction to either party, or uncertainty of the ability of one party to honor the contract. The Islam has forbidden the purchase of the unborn animal in the mother"s womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to distribution, the purchase of charities prior to their receipt, and the sale of fish in the sea. All Islamic finance scholars agree that Gharar should be avoided in commercial exchange contracts. As Islamic Shariah forbids riba (interest) because it leads to exploitation and injustice in the society, it also forbids Gharar in any transaction to protect the two parties from deceit, ignorance, and uncertainty. All Islamic financial and business transactions must be based on transparency, accuracy, and disclosure of all necessary information, so that no one party has advantages over the other party. Islam has clearly forbidden all business transactions, which cause injustice in any form to any of the parties. It may be in the form of hazard leading to uncertainty in any business, or deceit or fraud or undue advantage. The rationale of Prohibition of Gharar is to ensure full consent and satisfaction of the parties

in a contract. Without full consent, a contract may not be valid. Full consent can only be achieved through certainty, full knowledge, full disclosure, and transparency. Tabash et al (2014)

### 3.1.4 Sanctity of contracts

Islam teachings uphold contractual obligations and related disclosure of information as a sacred duty. Full disclosure is intended to reduce financial speculation (gambling), which is strictly prohibited by Islam, by providing as much information as possible for investors to make accurate assessments about the risks and rewards of an investment. The conditions that are necessary for a contract to be valid include a competent understanding of the underlying assets and the profit-sharing ratio, as well as the presence of a willing buyer and seller. Contracts must also not offend Islamic religious and moral principles; if they do, they will be deemed illegal and unenforceable (Shanmugam, 2009).

### 3.1.5 Shari'ah-approved activities

Islamic finance integrates Islamic moral and ethical principles and, as such, prohibits financing harmful products and activities. For example, Islamic banks prohibit financing to such industries as alcoholic beverages, tobacco, casinos, and pornography. Islamic banks do not participate in financing activities that are harmful to society and that would consequently hinder development. Project finance, which puts emphasis on equity participation in transactions involving real assets, is natural fit for Islamic finance. By following this principle, Islamic banks improve the productivity in the economy and reduce the social and economic costs of such harmful products and services (Siddiqi, 1999). To ensure that all products and services offered are Shar'iah compliant, each Islamic bank has an independent Shari'ah supervisory board.

### 3.1.6 The usage of money as potential capital

Money is treated as "potential" capital - that is, it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is "potential" capital. Money is a means for conducting transactions and not a commodity to be traded. Islam recognizes money as a medium of exchange and prohibits the sale of money as a commodity. The Islamic concept of money is such that the value of money is the reflection of the value of the commodity and has no value of its own. Therefore, it is not to be traded but to be used as a medium of exchange in order to facilitate the transactions undertaken by the society.

## 4.0 Tutor-Marked Assignment

Examine the implications of the Fundamental Principles of Islamic finance to social welfare.

## 5.0 Summary and Conclusion

In this unit, we have discussed basic principles that guide the operation of Islamic financial system. We have also stated the reasons/rationale for the application of these principles to enhance social welfare and productivity. We expect these discussions to create knowledge and understanding of the workings of the Islamic financial system to students.

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## UNIT FOUR: MODELS OF ISLAMIC FINANCE

1.0 Introduction
2.0 Objectives
3.0 Main Content
  3.1 Single Islamic Banking System
  3.2 Dual System
  3.3 Hybrid System
4.0 Summary and conclusion
5.0 Self- study Question
6.0 References

### 1.0 Introduction

In this unit, an explanation of the types of Islamic financial system models being practiced across the globe will be presented. Basically, there are three models in practice based on the peculiarities of the countries regulations. These are single, dual and the hybrid system.

### 2.0 Objectives

This unit is designed to achieve the following:

- Introduces the various model practiced in Islamic finance industry around the globe
- Enable the students to identify the right models in practice in various countries of world
- To be able to distinguish between the models as far practice by the students

### 3.0 Main Content

#### 3.1 Single Islamic finance model

This exists where only single laws and regulations prevail in a jurisdiction i.e either conventional or Islamic. Single Islamic financial system is practiced where only Islamic laws (Shari'ah) exist in the nation, example Iran, Sudan. It consists of Islamic financial institutions (central banks, banks and non-banks) and financial markets and their regulators (securities and exchange commissions). All regulatory and supervisory provisions are issued in line with the Shari'ah principles. In the early 1980s, Pakistan, Sudan and Iran were among the first to adopt a single banking system that sought to fully

implement Shari'ah principles. Within a short period of time all financial institutions in these countries had to comply with Shari'ah principles and exclusively provide Shari'ah-compliant financial services. Other countries, including Malaysia, United Arab Emirates, Kuwait and Bahrain adopted a more gradual approach that lead to the creation of a dual banking system. Kabir, Rasem & oseni (2013)

### 3.2 Dual System

Islamic and conventional laws coexist in one jurisdiction, example Malaysia, Bahrain, Indonesia, and Brunei. Islamic Banking Act and Takaful Act coexist alongside with Banking and Financial Institutions Act and Insurance Act respectively. Within this category, there are variations with regard to the role of regulators in Shari'ah compliance.

### 3.3 Hybrid System

Amendments made to specific sections of rules and regulation with regard to the financial markets to make it Islamic finance friendly, examples Singapore, UK

## 4.0 Summary and Conclusion

The development of Islamic finance is a worldwide occurrence, but each jurisdiction adopts varying approaches to develop the Islamic financial system. The success of each model depends on the regulatory framework of the jurisdiction in question.

## 5.0 Self- Assessment Exercise

Distinguish between hybrid and dual Islamic financial system with examples.

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## MODULE 2: STRUCTURE OF ISLAMIC FINANCIAL SYSTEM

**UNIT ONE: Islamic Financial Institutions (IFIs)**

**UNIT TWO: Islamic Financial Markets**

**UNIT THREE: Islamic Financial Instruments**

**UNIT FOUR: Challenges facing Islamic Financial Institutions**

## UNIT ONE: ISLAMIC FINANCIAL INSTITUTIONS

**Content**


**1.0 Introduction**
**2.0 Objectives**
**3.0 Main Content**
- **3.1 Meaning and Nature of Islamic Financial Institutions**
- **3.2 Role of Islamic Financial Institutions**
- **3.3 Characteristics of the Islamic Financial Institutions**

**4.0 Self-study Questions**
**5.0 Summary and Conclusions**
**6.0 References/Further Readings**


### 1.0 Introduction

In this unit, we will discuss the Islamic financial institutions as intermediaries in the Islamic financial system, their roles and basic characteristics that distinguish them with the conventional financial institutions.

### 2.0 Objectives

At the end of the study, students are expected to understand the following:

- Islamic financial institutions operating within the Islamic Financial System
- The role Islamic financial institutions play in financial intermediation
- The key characteristics of Islamic institutions

## 3.0 Main Content

### 3.1 Meaning and Nature of Islamic Financial Institutions

An Islamic financial institution is an organization that performs all the typical functions of financial intermediation while retaining its Islamic character. It undertakes both (i) mobilization of funds from savings-surplus economic units (usually household sector) through an array of financial assets (deposit products) and (ii) channeling of funds into profitable projects floated and operated by savings-deficit economic units (usually corporate and government sector). While conventional banking uses the interest rate mechanism to perform its task of financial intermediation, Islamic banking relies on profit/loss sharing for purposes of financial intermediation.

Islamic financial institutions offer a range of products and services that are supposed to meet the tests of *Shariah*. Below we provide an overview of the products and services and the underlying *Shariah*-nominate contracts. There are exchange-based contracts, such as, *murabaha, bai-bithaman-ajil, ijara, salam, istisna, istijrar* that create debt and hence, underlie debt-based financing products and securities. There are participatory contracts, such as, *mudaraba* and *musharaka* that underlie equity-based financing contracts and securities. These also underlie some deposit products used for mobilizing funds from the Savings- Surplus-Units (SSUs) in the economy. There are contracts, such as, *wadi'ah, amana, qard* that underlie deposit products. There are contracts, such as, *wakalah* and *ujr* that underlie many fee-based products.

Islamic financial institutions (IFIs) also serve as intermediaries between the saving surplus and the deficit units/households. However, the instrument of "interest" is replaced by a number of instruments. While conventional banks mainly pay and charge interest in their operations, Islamic financial institutions have to avoid interest and use more than one key instrument as the basis of their intermediary activities. The striking difference is that risks in Islamic banking remain with the ownership, as a result of which, IFIs share profit or loss arising on investments and earn return on their trading and leasing activities by dint of the risk and liability taken and adding value in real business activities. They mobilize deposits on the basis of profit/loss sharing and to some extent on the basis of Wakalah against pre-agreed service charges or agency fees.

IFIs will remain as intermediaries, as they collect savings from a large number of savers/investors for financing the needs of business, agriculture and industry, but their modus operandi will change. Their subject matter will be goods and real business activities.

According to Dusuki and Abdullah (2006) almost 25 percent of Islamic financial institutions now operate in countries that do not have Muslim majorities and interest-based banks have opened up "Islamic windows" to attract the growing number of Muslims living in Europe and North America. Some banks in Nigeria equally have "Islamic window" for example Mainstreet bank, Stanbic IBTC, United Bank for Africa,

etc. Based on these, one can argue that Islamic banking is no longer regarded as a business entity striving only to fulfill the religious obligations of the Muslim community, but more significantly, as a business that is ineluctably in need for winning over customers and at the same time retaining the old ones for economic development. Bley and Kuehn, (2005) argued that Islamic financial services sector is growing at double digit rates.

However, Islamic financial institutions comprises a number of financial intermediaries broadly classified as Islamic banking institutions (IBI) consisting of central bank, Islamic commercial banks, investment banks, Islamic microfinance banks and non- bank Islamic finance institutions (NBIFs) such as Islamic insurance(Takaful), Islamic mutual funds, Zakat, Waqf and Islamic finance companies offering a range of financial services.

### 3.1.1 The Central Bank of Nigeria: An Overview of its Establishment and Operations

The CBN came to existence consequent upon the G.D. Paton report for the period of 1892-1952 on banking practice in Nigeria, which eventually led to the first Banking Ordinance of 1952. However, the CBN Act 1958 was actually the legal framework upon which the CBN was established. This Act was later amended in 1969 through the Banking Decree of 1969 (CBN, 2011b). Importantly, the Bank and other Financial Institutions Decrees (BOFID) 24 and 25 of 1991 repealed the Banking Decree of 1969 and all its amendments. As a result, the CBN became strengthened to cover new institutions like Non-Interest banking. The power of the CBN was enhanced in order to make effective monetary policy, regulation and supervision of banks and other financial institutions. In 1997, BOFID 3 and 4 were promulgated which abolished the limited autonomy of the CBN since 1991 and thus brought the CBN under the supervision of the Ministry of Finance. Again, Decree No.3 of 1997 was amended through the promulgation of Decree No. 38 of 1998 which provides a measure of operational autonomy for the CBN. This Decree was enacted to strengthen the regulatory powers of the CBN (CBN, 2011a). It needs to be stated that the current legal framework of the CBN is based on the CBN Act of 2007, which repealed the CBN Act of 1991 and all its amendments. This new Act provides for the full autonomy of the CBN with the objective of promoting stability and continuity in economic management. In view of this enabling legal provisions for the CBN, it now controls, regulates and supervises all banks and non-banking institutions in the economy (CBN, 2011b). No wonder therefore that the mission statement of the CBN aptly captured this unique role in the following words: “To be proactive in providing a stable framework for the economic development of Nigeria through the effective, efficient and transparent implementation of monetary and exchange rate policy and management of the financial sector” (CBN, 2011b). The CBN core values are based on Meritocracy, Leadership, Learning and Customer-Focus among others, which are meant to serve as guide to both the management and employees. Based on these autonomy and its enduring core values, the CBN has been able to carve a niche for itself in the area of central banking in the world, especially when it made some landmark strides in recent times. For instance, as a way of driving the development process and improving the banking operational efficiency in 2004, the bank consolidation policy was

introduced. This policy required all existing and about to be formed banks to have initial capital of N25 billion against the earlier policy of N2 billion. This policy decision is in line with its core values and principles. To this end, the figure below covers the entire core values of the bank, which have continued to be it source of strength and focus over the years.

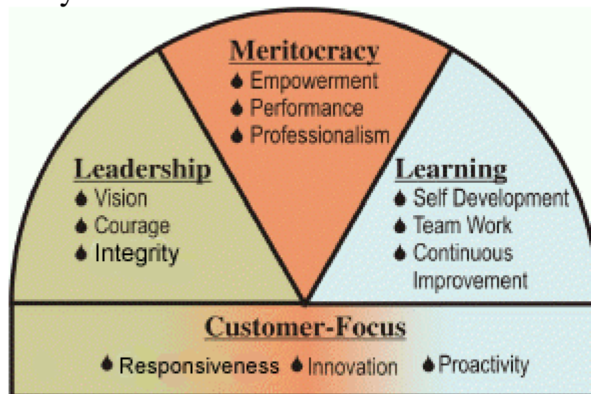


**Figure 1: The Core Values of CBN Source: CBN (2011b).**

These core values of the CBN have assisted in the landmark policies and achievements witnessed in recent times. Prominent among them are the Bank consolidation and Rescue mission policies of the CBN. The Governor of the CBN noted these important achievements when he submits thus: "As a result, banks were consolidated through mergers and acquisitions, raising the capital base from N2 billion to a minimum of N25 billion, which reduced the number of banks to 25 from 89 in 2005 and later to 24" (Sanusi, 2011b, p. 5). Similarly, as a form of direct rescue package of the Apex bank, the sum of N620 billion was injected into eight banks who are at the point of collapse in recent times. Related to this rescue mission was the appointment of new management teams for these banks as a way of enhancing the corporate governance of the failing banks. Sequel to these pragmatic policy actions by the CBN, the larger size of banks engendered improved customer confidence, which led to the increase in the number of banks in the country i.e. from 3,247 in 2003 to over 5,837 in 2010. Also, employment witnessed a boost in the sector because it rose from 50,586 in 2005 to 71,876 in 2010 (Sanusi, 2011b). Therefore, forward policy looking of the CBN has brought about a healthy financial sector, which reviewed the basic one-size-fits-all model of banking. This policy reform has made it possible for the emergence of international, national, regional, mono-line and specialized banks such as non-interest banks among others, with different capital requirements commensurate to the depth of their operations. Hence, the CBN by virtue of its position as the major stakeholder in the financial system regulation must necessarily be involved in the establishment, operation and regulation of IBs in the country. On this position, Usman (2003, p. 39) submits: "The Central Bank stands at the apex of the banking system of every country".

### 3.1.2 Islamic Banking

Islamic banking is a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic *shari'ah* (Jurisprudence) and forbid the

receipt and payment of interest on any of its transactions (Kalaithasan & Mohamed, 2007)

Islamic Banking is an interest-free banking system which emerged in the global scene barely four decades ago. The definition of Islamic banking system is essentially any banking system that complies with the economic value system of Islam. The Islamic banking business has emerged as an ethical banking system which is primarily meant to cater for the interests of large number of the world population.
Islamic banks engage in three major services: free services, services rendered by banks on fixed exchange, commission or discount, and creation and development of funds. The development of Islamic banking system has demonstrated its potentiality of being used as a viable global financial intermediary. The crystallization of the Islamic banking system in the 21st century has made it a force to be reckoned with to avert any future global economic crunch.

Islamic bank is defined as the banking system that is consistent with Islamic principles and guided by Islamic economics. Islamic banking is also defined as an interest-free form of banking that conducts banking businesses, participates in exchange, investment and commercial activities as well as providing products and services under the doctrines and rules of Islamic jurisprudence (Seyed-Javadin *et al*., 2014).

According to CBN (2011, p1) Islamic bank is "a bank or other financial institution (OFI) under the Central Bank of Nigeria (CBN) which executes banking business, engages in trading investment and commercial undertakings as well as provision of financial products and services in accordance with the ideologies and rules of Islamic commercial jurisprudence".

In sum, Al-Jarhi and Munawar Iqbal (2001) have described the operational set-up of an Islamic bank in the following words:
"An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilizes funds on the basis of a Mudarabah or Wakalah (agency) contract.
It can also accept demand deposits, which are treated as interest-free loans from the clients to the bank and which are guaranteed. On the assets side, it advances funds on a profit-and-loss sharing or a debt-creating basis, in accordance with the principles of the Shari´ah. It plays the role of an investment manager for the owners of time deposits, usually called investment deposits. In addition, equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations. An Islamic bank shares its net earnings with its depositors in a way that depends on the size and maturity of each deposit. Depositors must be informed beforehand of the formula used for sharing the net earnings with the bank."
Non-interest banking originated from both Christian and Islamic scriptures, as stated in the Holy Quran (2:275), as well as the Bible in Leviticus (25:36-37), Deuteronomy (23:19) and Ezekiel (8:33): "You shall not lead upon using to your brothers usury of

money, usury of victuals, and usury of anything lends upon another (Khan, 2010). Islamic banking is not a new system of banking, it has been in existence for more than four decades, and it operates in some countries such as Pakistan, Egypt, Britain, and the United States of America (Cihak, 2010)

### A Islamic Banking Model

There are broadly three models of organizational structure that the banks can adopt, according to their span of activities: the "Universal Banking Model", the "Bonafide Subsidiary Model" (all subsidiaries having their own capital and separate operations) and the "Bank Holding Company Model" (a bank holds separate organizations owned by itself for different activities, e.g. investment banking, Murabaha/trading transactions, commercial banking, etc.). The first two models may not best suit Islamic banks because of the wide difference in the nature of activities that they will have to adopt for their operations. Khan (1999)

The fully owned (by the parent bank) subsidiaries model is best suited to banks if they establish a number of subsidiaries for various types of operations, namely investment banking, commodity trade-based banking, leasing-based banking, Istisna'a-based banking and the normal commercial banking. Alternatively, IFIs can have special branches for industry, agriculture, commerce, and real estate and Takaful businesses. The modes available to banks/their subsidiaries in order of priority will be Musharakah/equity participation, Mudarabah or profit-sharing and loss-absorbing, Ijarah and trading in real goods or sale contracts with deferred payment (Bai' Mu'ajjal) or with deferred delivery of goods (Bai' Salam and Istisna'a). ISRA (2011)

In theory, the business model of Islamic banks differs from conventional banks. Islamic banking rests on a two-tier *mudârabah* and *wakalah* model.

In a *wakalah*-based trade financing, clients approach the bank to act as their agent or *wakeel* and to provide a letter of credit facility. The bank requires the client to place the full amount of the goods to be purchased in a *wadi'a* or deposit account. The bank then makes payment to the counterpart bank and the pertinent documents are released to the client, who pays a fee or commission under the principle of agency fee or *ujr*. Mumtaz et al (2015)

In a "*two-tier mudaraba*" model, the basic concept of this model as originally developed by Khan (1986) is that both funds mobilization and funds utilization are on the basis of profit sharing among the investor (depositor), the bank and the entrepreneur. The first tier *mudaraba* contract is between the investor and the bank, where investors act as suppliers of funds to be invested by the bank on their behalf as *mudarib*; the investors share in the profits earned by the bank's business related to the investors' investments. Funds are placed with the bank in an investment account. The liabilities and equity side of the bank's balance sheet thus shows the deposits accepted on a *mudaraba* basis. Such profit-sharing investment deposits are not liabilities (the capital is not guaranteed and they incur losses if the bank does so), but are a form of limited-term, non-voting equity. The second

tier represents the *mudaraba* contract between the bank as supplier of funds and the entrepreneurs who are seeking funds and agree to share profits with the bank according to a certain percentage stipulated in the contract. In this model, in addition to investment deposits, banks would accept demand deposits that yield no returns and are repayable on demand at par value and are treated as liabilities. A distinguishing feature of the "two-tier" model is that, by design, the assets and liabilities sides of a bank's balance sheet are fully integrated and thus minimize the need for active asset/liability management, which provides stability against economic shocks. Early claims of superiority of Islamic banking over conventional banking were based on this model propounded by Khan (1986) that demonstrated that the former are far more robust than the latter in absorbing external shocks.

When the above theoretical model was put into practice, the operation of Islamic banks envisaged three main sources of funds and four principal uses of these funds. The three sources of funds are: (i) the bank's share capital (ii) *mudaraba* deposits, and (iii) demand deposits. The four principal uses of these funds are (i) *mudaraba* financing (ii) financing on the basis of the principles of *musharaka* (iii) purchase of ordinary shares of companies and (iv) *qard alhasanah*.
Later models took cognizance of the fact that Islamic banks may need to branch into certain other activities to deploy their funds.

Islamic commercial banks play the role of intermediaries in the financial system. They source funds by offering a variety of deposit products – *wadiah* and/or *qard*-based current account deposits, *mudaraba*-based savings account and investment account deposits and the like. They use funds through a variety of financing products – equity based and debt-based. Islamic equity-based financing products comprise trustee partnership (*mudaraba*) facility, joint venture (*musharaka*) facility, declining partnership (*musharaka*) facility and the like.
Islamic debt-based financing products comprise cost-plus sale (*murabaha*) with deferred payment (*bai-bithaman-ajil*) facility, leasing (*ijara*) facility, deferred delivery sale (*salam*) facility, manufacture-sale (*istisna*) facility, recurring sale (*istijrar*) facility, benevolent loan (*qard*) facility and the like. Islamic commercial banks have also been offering a few highly controversial and unacceptable financing products, such as, repurchase (*bai-al-inah*), bill discounting (*bai-aldayn*), tripartite resale (*tawarruq*), short-term cash loan & credit card based on *tawarruq* and *bai-al-inah.* Islamic commercial banks also provide a range of feebased services, such as, opening of letter of credit (*wakala) and* letter of guarantee (*kafala*). Ayub (2007)

Islamic investment banks play the role of facilitators where the flow of funds is direct. They help the Savings-Deficit-Units (SDUs) in the economy create and offer various Islamic securities called *sukuk* to the SSUs. These *sukuk* are based on and hence named after the underlying *Shariah*-nominate contracts. Islamic debt securities comprise *murabaha sukuk*, *ijara sukuk, salam sukum* and *istisna sukuk*. Islamic equity securities comprise *mudaraba* and *musharaka* certificates. Ayub (2007)

So today, by Islamic banking, one does not mean a mere lending institution extending interest-free loans, but a package of Shariah-compliant (strict adherence to Islamic economic norms) financial services like Islamic mutual funds, Islamic bonds (Sukuk), Islamic insurance (Takaful), Islamic credit cards and other technology-driven services like Automated Teller Machines (ATMs) and online banking, all of which have a tremendous market in the world.

### B Islamic Banking and Finance in Nigeria- (Its Establishment)

The emergence of Islamic Banks in several Muslim and non-Muslim countries with none in Nigeria ignited the desires and agitations, which eventually generated a lot of concerns for its absence in Nigeria despite its overwhelming Muslim population. This therefore informed the enormous efforts being made over the years to ensure the establishment and operation of IBs in Nigeria. The efforts date back to the 1990s when the idea was first mooted and subsequently, two licenses were granted in 1992. Unfortunately, none could commence operation until 1999 when the former Habib Nigeria Bank Limited (now Bank PHB) started a non-interest banking window. However, it is important to state that the promulgation of the Banks and Other Financial Institutions Decrees (BOFID) 24 and 25 of 1991, which replaced the Banking Act of 1969 signaled a new dawn for banking operation in Nigeria (CBN, 2011b; & Usman, 2003). This is in view of the new provisions made for the establishment of non-Interest banking in the country. It is also interesting to state that the recent attempt by the Central Bank of Nigeria at enacting additional provisions for the proper establishment and operation of Islamic banking in the country is indeed a welcome development. Furthermore, the CBN in August 2010 released the new banking model, which categorized non-interest banks as specialized banks. The two models are: i) National non-interest bank of capital base of N10 billion with operation in every state of the federation including the Federal Capital Territory (FCT); and ii). Regional non-interest bank with capital base of N5 billion and shall operate in a minimum of six states and maximum of twelve contiguous states of the federation (Umar, 2011). This development is certainly an encouraging one and it is hoped that this legal and regulatory framework shall fuel the establishment and operation of Islamic banking in Nigeria. This is in view of the growing awareness of the Muslim populace and the desire to have an Islamic financial institution like other Muslim countries. Hence, with this recent circular, the major problems of regulatory and supervisory issues are close to solution. Therefore, according to the circular, a Non-Interest Financial Institution (NIFI) is defined as: “a bank or Other Financial Institution (OFI) under the purview of the CBN, which transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services are in accordance with Shari’ah principles and rules of Islamic commercial jurisprudence” (CBN, 2011a, p. 1).

Essentially, it needs to be stated that Nigeria is the most populous country in the African continent and the 8th most populated country in the world with location on the West Coast of Africa bordering the Gulf of Guinea between Benin and Cameroon (Central Intelligence Agency, 2011). The country has a Muslim population of over 80 million,

which denotes a population almost equals the entire Muslim population of Algeria, Morocco and Tunisia (three North African countries). Indeed, this presents a substantial and huge market for Islamic banking operation in the country, particularly with the enthusiasm and readiness so far demonstrated by majority of the Muslims. Albeit, recent efforts on the parts of the CBN and Muslim professionals, especially economists, bankers and administrators revealed that very soon Islamic banking operation shall take-off. This development as noted by CBN (2011a), is in view of the increasing number of requests from persons, banks and other financial institutions like Jaiz Bank International, which was incorporated in April 2003 with the main objective of being an Islamic investment holding company to set-up non-interest institutions like Islamic bank, Takaful (Islamic Insurance) and Pension Fund Administration among others. Nevertheless, the current circular released by the CBN on the framework for Non-Interest Financial Institutions has added a lot of glamour to the prospect of Islamic banking project in the country. For instance, the introductory aspect states clearly the various non-permissible transactions, contracts and instruments. In the same vein, Section 5.0 also spell-out unambiguously the recognized and permissible modes of financing. In response to the positive step taken by the CBN, the Nigeria Deposit Insurance Corporation (NDIC), September 2010, released its exposure draft on Non-Interest Deposit Insurance Scheme for stakeholders" comment. Another effort manifested when Banks and Other Financial Institutions (BOFI) Act No. 25 was enacted. Section 61 of BOFI Act recognized the establishment of profit and loss sharing bank in the country, which basically is the Islamic form of banking.

In the same vein, Lotus Capital limited is a halal fund established in the year 2004 (an ethical investment fund), has been operating as an Islamic financing company dealing in shariah compliant investment and fund management activities. Furthermore, the first full-fledged Islamic microfinance bank, Al-Barakah microfinance has commenced operations in April, 2010 in Lagos, and more recently, the first full-fleged non-interest bank in the name Jaiz Bank Plc commenced operations as a regional bank in January, 2012, in Abuja, Kano and Kaduna, in Nigeria. In 2019, the second full-fledged Islamic bank, Taj Bank, was also issued a regional license by the apex bank.(CBN)

Although, likely problems and challenges to confront the Islamic banking project include capital inadequacy, lack of Shari'ah governance institutions, manpower shortage, Islamaphobia on the part of non-Muslims and a host of others.

The Following are the Different Categories of Islamic Financial Services (IFS) of IFIs in Nigeria:

· Full-fledged Islamic bank or full-fledged Islamic banking subsidiary of a conventional bank;
· Full-fledged Islamic merchant or full-fledged Islamic banking subsidiary of a conventional merchant bank;
· Full-fledged Islamic microfinance bank;
· Islamic branch or window of a non-bank financial institution;
· A development bank regulated by the CBN offering Islamic financial services;

· A primary mortgage institution licensed by the CBN to offer Islamic financial services either full-fledged or as a subsidiary; and
·- A finance company licensed by the CBN to provide financial services, either full-fledged or as a subsidiary. Mustafa et al (2011)

CBN new banking model allows the establishment of the following banking structure as defined by BOFIA 1991:
· Commercial Banks
· Merchant Banks and
· Specialized Banks
Specialized Banks include non-interest banks, microfinance banks, development banks, mortgage banks, and such other banks as may be designated by the CBN from time to time. Guidelines for some of the specialized financial institutions, e.g., microfinance banks primary mortgage institutions and finance companies have been issued under a separate cover. Guidelines for other categories of non-interest banking will be issued upon request which shall be consistent with international best practice. Suleiman (2018)

### C. Benefits of Islamic Banking

- There is a need for alternative to conventional finance whose interest-based factor has promoted capital rather than elevates poverty.
- It reduces exploitation of the conventional bank that charges interest.
- It attracts other idle money, tinny Muslims do not see saving banking is operating they will be encouraged to bring in their money consequently more money to economic development.
- It enhances the creation of employment, owning to its mode of operation which gives more chance to direct access to financial opportunity more than conventional banks through Musharakah, Mudarabah etc.
- The introduction of non-interest banking will herald the entry of market and institutional players such as Islamic Money Market, Islamic Asset Management Companies (Islamic Insurance) companies and so on, thus deepening the financial market.

### 3.1.3 Islamic Microfinance

Islamic microfinance represents the confluence of two rapidly growing industries: microfinance and Islamic finance. It has the potential to not only respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance’s power to provide financial access to the poor. Unlocking this potential could be the key to providing financial access to millions of Muslim poor who currently reject microfinance products that do not comply with Islamic law. Islamic microfinance is still in its infancy, and business models are just emerging.

### 3.1.4 Takaful (Islamic Insurance)

Takaful is the Islamic counterpart of conventional insurance, and exists both in life (or “family”) and general forms. It is based on concepts of mutual solidarity, and a typical

Takaful undertaking will consist of a two-tier structure that is a hybrid of a mutual and a commercial form of company. The distinct feature of takaful is that the participant and the fund operator are clearly segregated and the reward for the operator is conditional upon which model of takaful is used.

There are three takaful models:

- Mudarabah
- Wakala
- Waqf

The core theoretical model is based on a framework that is mutually beneficial and cooperative. Due to remuneration demands from contributors in exchange of fund participation, two models were created for takaful, which are the wakalah and mudarabah.

The main concept of Islamic insurance is that it is an alternative to conventional insurance, with characteristics and features that comply with *shariah* requirements.

This is done by eliminating the objections against conventional insurance. "The term *takaful* is an infinitive noun which is derived from the Arabic root verb *kafal'* or *kafala,* meaning to guarantee or bear responsibility for." (Kassar *et al*. 2008, p.26).

The main features of Islamic insurance are:

- cooperative risk sharing by using charitable donations to eliminate *gharar* and *riba*;
- clear financial segregation between the participant (insured) and the operator (insurance company); and
- *shariah*-compliant underwriting policies and investment strategies.

**Cooperative Risk-Sharing**

The characteristics of a cooperative include self-responsibility, democracy, equality, equity, solidarity, honesty, openness, social responsibility, and caring for others. While mutuality or cooperative risk-sharing is at the core of Islamic insurance, it cannot alone create an Islamic insurance operation. Islamic insurance is based on more than one contractual relationship: the first relationship is a mutual insurance contract between policyholders (contributors) and each other. This is similar to a pure mutual insurance relationship, taking into consideration the concept of donation *(tabarru)* instead of premiums and an ethical framework of Islamic transactions. The main features behind cooperative insurance are as follows.

• Policyholders pay premiums to a cooperative fund with the intention of it being a donation to those who will suffer losses (*tabarru*).

• Policyholders are entitled to receive any surplus resulting from the operation of the cooperative insurance fund.

• Policyholders are liable to make up for any deficits that result from the operation of the cooperative insurance fund.

• The amount of contribution (premium) differs from one participant to another, based on the degree of risk in general insurances and actuarial principles in life assurance.

• There is no unified system to operate the treatment of surplus and deficit. There is therefore more than one model accepted by *shariah* scholars being used in practice.

**Clear Segregation between Participant and Operator**

In conventional insurance, the insurance company is a profit-making organization that aims
to maximize profit by accepting the financial burden of others' losses. The insurance company is owned by shareholders who are entitled to receive any profit and are responsible for financing any deficit. Under Islamic insurance, the system is that the insurance company's role is restricted to managing the portfolio and investing the insurance contributions for and on behalf of the participants. The relationship between the participants and the insurance company (as an operator, not as an insurer) is different. There are four different models in operation: the *mudarabah* model, the *wakalah* model, the hybrid *mudarabah–wakalah* model, and the pure cooperative model (nonprofit). "The overarching goal of Takaful is brotherhood, solidarity, protection and mutual cooperation between members. (Kassar *et al*. 2008, p. 66).

***Shariah*-Compliant Policies and Strategies;** requires ethical insurers invest money in a responsible way in industries that are ethically sound and do not harm the environment or people. Islamic insurance is similar, except that the ethical considerations are extended to those which do not contravene the religion of Islam and are monitored by a *shariah* board, which is part of the company structure. In particular, the investment and underwriting policies need to be free of any involvement with the prohibited activities of gambling, alcohol, pork, armaments, tobacco, and interest-bearing activities, loans, and securities.

### 3.1. 5 Islamic Investment Fund

The term 'Islamic Investment Fund' generally refers to a joint pool wherein investors contribute their surplus money for the purpose of its investment to earn profits in strict conformity with Shariah principles. The distinguishing feature between an Islamic investment fund and a conventional one is that while the Islamic investment fund follows the Shariah principles, the conventional fund does not.

Fund management companies are specialized financial institutions that help investors in gaining a relatively high return on investment at a lower risk. Investors subscribe to the units issued by the fund managers and entrust with them their funds. These units represent the equity holding of the investors and can be bought and sold as per their Net Asset Value on every trading day. The fund manager pools together the funds of investors to form a large pool. This large pool is then invested as per the guidelines provided by the Shariah board, by specially trained personnel or a fund manager. Profits and income shall be shared among the investors and the fund manager as per the agreement. The manager distributes the profit share of the investors. The investor can redeem the units by selling it to the fund manager on Net Asset Value (NAV).

An Islamic investment fund functions in a manner similar to a mutual fund. It executes its functions in the form of a legal entity. The legal form of the fund depends on many factors and can vary as per the requirement. However, an Islamic investment fund can generally be in any of the legal forms discussed below:

**i. Company**

**ii. Trust**
**iii. Partnership**

**Islamic Fund as a Company:**
In a company form, the fund manager takes on the role of a board of directors and investors act in the capacity of shareholders. Shareholders would give the mandate of managing the invested fund to the board of directors. In such a scenario, the provision of the company law in the jurisdiction where the fund has been incorporated also governs the fund. This form is particularly preferred in the Middle East region.
**Islamic Fund as a Trust:**
In a trust form, the investors appoint a fund manager as a trustee to manage and invest the funds of the trust. The trust law takes effect and the trustee has a fiduciary responsibility to manage the funds.

**Islamic Fund as a Partnership:**
In a partnership form, the fund manager plays the role of a general partner and investors play the role of an ordinary partner. The general partner is responsible for handling the funds.
No matter what form is adopted, the roles and responsibilities of the parties remain more or less the same. The fund manager is responsible for managing the funds and providing returns to the investors.
There are various parties like investors, the fund manager, Shariah board and others who come together, as a result of a contractual relationship, to structure an Islamic Fund.

**Parties Involved In Islamic Fund:**
a. Investors: Investors are the individuals or institutions who own the shares or units of the fund and entrust their surplus for investment to the fund manager.
b. Fund Manager: Fund Manager (individual or company) is the trustee/custodian of the investor's surplus and acts on their behalf or in their interest.
c. Shariah board: Shariah board consists of the Shariah scholars who provide Shariah guidelines to the fund to ensure that the investment is compliant with the principles of Shariah.
d. Others: The term 'Others' include third parties or other mutual funds with whom the fund manager enters into different contracts for the purpose of investment or the distributors who bring investors into the fund scheme against the commission, etc.
The contractual relationship between investors and the fund manager is the most important as it originates the structure of the fund. An Islamic fund can be incorporated using any of the structures discussed below:
i. Mudaraba
ii. Wakala (investment agent)
ii i. Musharaka
An Islamic Investment fund consults Shariah advisers to ensure that investment operations and portfolios are managed in compliance with Shariah principles. The

Shariah board acts as an independent or external consultant to the fund. The major regulation of Islamic fund from the Shariah perspective is done with respect to screening and purification. Marifas(2014)

### 3.1.6 Zakat

Zakat literally means “to be clean, to grow, to increase.” It comes from the root letters za, kaf, ya, which has several meanings: to be clean [Al-Quran Chapter 24: Verse 21, Chapter 23: Verse 4], to pay the obligatory charity [Al-Quran 2:43], to be pure, innocent [Al-Quran 19:19, 18:74], to be better in purity [Al-Quran 18:81, 19:13], and to praise oneself, to justify [Al-Quran 53:32]. It has been used in the Quran to mean all of these things. It can also be considered a form of sadaqah (charity), given to the poor. Zakat is also known as zakah.

**Zakat is:**

- Levied on specific assets only, identified by Shariah (Islamic Law) as assets having the potential for growth.

- Levied at the rate of 2.5% each year (calculated according to the lunar calendar*) on the market value of the Zakat-able assets after deducting therefrom specified liabilities.

The compulsory transfer of ownership of a portion of the property of the giver, calculated at the rate of 2.5% as aforesaid, to a poor and needy Muslim who qualifies to receive Zakat according to the Shariah.

- An Ibada’h (worship) and not a tax, Obligatory on every Muslim who owns Nisab viz. 613.35 grams of silver, or 87.49 grams of gold or who owns one or more assets liable to Zakat as set out below, equal in value to 613.35 grams of silver or 87.49 grams of gold.( Chaudhery, *M.K. Hassan and Md. Sharif Hussain,)*

Zakat is collected from all well-to-do Muslims in an Islamic state, and redistributed totally for the purpose of improving social welfare among the needy. Zakat is not a tax on current income, but it is a tax on wealth. Zakat puts an automatic check on the accumulation of hoarded capital or idle wealth in cash form and favors investment into real capital. Zakat has a strong multiplier effect on employment, output, profit and price stabilization through increased investment.

The multiplier effect of zakat is so strong that investment will be undertaken even when the expected rate of profit is zero. Zakat improves the general level of employment through its multiplier effect on investment. Higher capital expenditure in real investments brings about higher value added and thereby higher profits. The derived demand for labor would therefore increase as a result of the improved levels of capital expenditure and output. Zakat also reduces structural unemployment, which mainly arises in the deprived sector of the economy characterized by low human capital, poverty, age and debility.

### 3.1.6 Waqf

Waqf in Arabic means to stop, contain, or preserve. In Islamic terms, waqf refers to a religious endowment i.e. a voluntary and irrevocable dedication of one's wealth or portion of it, in cash or kind (such as a house or garden), and its disbursement for Shariah compliant projects, such as mosques or religious schools.

The difference between waqf and charity is that waqf is a permanent donation. Once a waqf is created, it can never be donated as a gift, inherited, or sold. Disbursement of the returns on the waqf is administered in accordance with the endower's wishes. Charity, on the other hand, is a broader concept. It encompasses alms, grants, inheritances, loans, waqf, and other forms.

**Waqf comes in 3 Forms:**

- **Family Waqf:** The endower of the waqf dedicates the fund to his/her immediate family or other friends or relatives. Upon the death of the waqf beneficiaries, the waqf can then be made into a charitable fund at the request of the endower.

- **Charitable Waqf:** This type of endowment is specifically utilized to help the poor, orphans, widows, or any other charitable cause.

- **Joint Waqf:** The joint waqf is a combination of both the family and charitable waqf.

The general goal of waqf is to help the needy, especially in unforeseen circumstances. The funds from waqf help build mosques and social welfare institutions such as, schools medical center, and facilities from people with special needs. Ahmad ((2004)

### 3.2 Key roles of Islamic financial Institutions

- Financial intermediation performed by IFIs is fairly comparable to financial intermediation performed by conventional financial institutions. To recapitulate, there are several roles played by financial institutions, whether Islamic or conventional, one of the most important roles played by financial institutions is to provide a link between lenders and borrowers of funds. Without financial institutions in place, it would be difficult for SFUs and DFUs to match directly in the market, or at least this matching would not be as efficient as it is through the intermediation of financial institutions. In the process, financial institutions collect relatively small savings from individuals, households and institutions and transfer them to deficit units, mainly businesses, for investment and production purposes.

- Financial institutions also gather and process information about economic conditions of markets as well as market players. This, in turn, leads to efficiency in financial markets by reducing the cost for raising funds in the market and maximizing the return on investment purposes. Absence of financial institutions

would make the channeling of funds between SFUs and DFUs very costly (as pointed out earlier) due to the complex process of financial structuring, legal documentation, accounting treatment and administrative follow-up. This is where financial institutions come into play. Through pooling a large number of savings and financial transactions under one management, financial institutions benefit from economies of scale whereby the cost per transaction reduces significantly as the number of transactions increase, and thus directly contributing to the efficient functioning of a financial system.

- In addition to matching the SFUs and DFUs between borrowers and lenders, financial institutions also provide two important services through asset transformation and risk transformation between market players. While SFUs prefer lending short, DFUs prefer borrowing long. This is where the asset transformation service provided by financial institutions comes into the picture. In the process, financial institutions transform relatively, short-term liabilities into long-term assets. Bello (2018)

However, this asset transformation is not risk free. In fact, different market players have different risk profiles and preferences. This is especially true for the last couple of decades when deregulation, liberalization, complexity and volatility of financial markets, resulted in the search by financial institutions for new products that will facilitate the mitigation, transfer and sharing of risks. Nevertheless, financial institutions are in a far better position to efficiently manage risks arising from both the liabilities and assets sides.

Several key developments highlight the rising role of Islamic finance in the global financial system:

a) Expanding asset base; the industry has recorded strong growth with total Islamic banking assets of USD660 billion at the end of 2007. Global Islamic finance assets reached $1.9 trillion by mid-2014 (ADB and IFSB, 2015), with about 75 percent of the industry concentrated in the Middle East North Africa (MENA) region (excluding Iran) where GCC countries accounted for 96 percent of it. Moreover, these assets are estimated to have surpassed the $2 trillion milestone at end-2014. In terms of geographical distribution, the Middle East is now the largest Islamic finance market, accounting for about 80% of global Islamic finance assets.

b) In terms of growth, the Islamic finance industry, including Islamic capital markets, grew, on average, by 17.5 percent since the onset of the global financial crisis in 2008 (Ernst and Young, 2015). The bulk of growth happened in countries outside the MENA region in countries with more Muslim populations, but most of the industry's growth in the MENA region was led by GCC countries. In particular, the Islamic finance industry

grew, on average, by 43 percent in Indonesia, and by 19 percent in Turkey during 2009–13.

c) Islamic banks dominate the Islamic financial industry, despite continued growth in *sukuk* and other *Shari'ah*-compliant financial assets such as Islamic funds and *takäful*. Islamic banking assets account for about 80 percent of total assets of the Islamic finance industry, albeit representing less than 1 percent of global banking assets. In 2013, Iran held the largest share of Islamic banking assets (about 38 percent), and Saudi Arabia and Malaysia accounted for nearly 29 percent of assets. IFSB stability report 2014

d) Development of comprehensive Islamic financial infrastructure. Several key institutions have been established to provide the infrastructure for the continuous growth of Islamic finance. Among the key institutions are the IFSB, AAOIFI and specialized institutions that provide Islamic financial services such as rating agencies, deposit insurance corporations and mortgage corporations. IFSB, an international prudential standard setting body was established in 2002 to develop and disseminate prudential standards for regulation and supervision of the Islamic financial services industry. AAOIFI, an accounting and auditing organization, is responsible to develop accounting and auditing standards for the Islamic financial institutions. Several international rating agencies have developed ratings methodologies that recognize and incorporate the unique features of Islamic finance. Bashir T (2018)

e) Specific scheme on Islamic deposit insurance has also been developed, while mortgage corporations have issued sukuk to facilitate the widening of asset classes available to investors in the Islamic capital markets. Complementing these initiatives are the efforts by the central banks in issuing Islamic monetary instruments which is integral to the functioning of the Islamic money market and the Islamic financial system.

f) Rapid expansion of the sukuk market. With regard to Islamic securities or sukuk, Thomson Reuters reported that the sukuk market grew from USD6 billion to USD24 billion between 2004 and 2007. The huge potential in the Sukuk market is evident from the active participation of global players including international investment banks, Islamic banks and securities firms that have participated in the issuance of sukuk. This development is also evidenced in Nigeria with the sukuk issuance by debt management office (DMO) on behalf of the Federal government to finance infrastructure. The sukuk issuance was successive for three years with first, second and third issues of over N100 billion each. Obaidullah (2005)

g) Reducing the impact of harmful products and practices; Shari'ah principles forbid any transactions that support industries or activities which are forbidden in Islam, for example, usury, speculation, pork, liquor, harmful drugs, prostitutions, and gambling, regardless as to whether these are legal or not in the place of transaction.

h) Encouraging stability in investments; In Islamic finance, investments are approached with a slower, insightful decision-making process, when compared to conventional finance. Companies whose financial practices and operations are too risky are usually kept away by Islamic financing companies. By performing intensive audits and analyses, Islamic financial system promotes the reduction of risk and creates the space for greater investment stability.

i) Accelerating economic development; Islamic finance companies certainly have profit creation and growth as their objectives. For which, they choose to invest in businesses based on their potential for growth and success. Thus in the Islamic banking industry, each bank will invest in promising business ventures and attempt to out-perform its competitors, in order to attract more funds from its depositors. This will eventually result in a high return on investments both for the bank and the depositors. This is unlikely in a conventional bank, where depositors redeem returns on their deposits based on a pre-determined interest rate.

### 3.3 Distinct Features of Islamic Financial Institutions

Under the conventional financial system structure, SFUs provide funds to DFUs through financial institutions by charging interest, on the liabilities side, financial institutions pay interest to savers/investor, and on the assets side, they charge borrowers a relatively higher interest rate. The spread between the interest paid and interest charged is the profit of the financial institutions. Since the charging and paying of interest is prohibited in Islam, financial intermediation under the Islamic financial system has some distinct features.

- To avoid interest, Islamic financial institutions use various contracts that are in line with Shari'ah teachings, better known as Shari'ah-compliant products. Islamic financial institutions thus, use equity, as well as debt-based financial instruments for the mobilization and use of funds.
- IFIs also encourage mutual benefits through profit and loss sharing principle as alternative to interest charging.
- Due to the differences in the nature of financial institutions and the way they engage their clients, especially long-term relationships in profit-and-loss sharing arrangements, there is a greater need for monitoring the entrepreneurs' activities. This, in turn, may imply higher costs and unique risks that are not present within the conventional financial system. In general, financial institutions are "exposed to several risks related to both the liabilities and assets sides of the balance sheet. These risks include interest rate, exchange rate, and liquidity risks that are related to both sides of the balance sheet. On the other hand, credit, market, and operational risks are related to the assets side of the balance sheet only. However, IFIs face certain risks that are associated with specific business models and Islamic contracts used in financial intermediation. Apart from the mentioned

risks, IFIs are faced with the rate of return risk, displaced commercial risk, fiduciary risk, Shari’ah-compliance risk, and reputation risk, among others.

- Unlike deposits placed in conventional commercial banks whose principal and return is assumed to be guaranteed, Islamic banks and financial institutions are not able to guarantee return on capital and profit. This is especially true for deposits and investments that are based on *mudaraba* and *musharakah* principles, while principal amount of deposits placed with an Islamic bank based on the principle of *amanah* are guaranteed by the bank without any guarantee on the profits of those deposits.
- Yet another distinct feature of IFIs is the existence of the Shari'ah advisory boards. Every Shari'ah advisory board consists of Shari'ah scholars who are well-versed in Shari'ah teachings. The existence and role of the Shari'ah advisory board is a unique feature of IFIs whereby their approval is needed before the introduction of any new product. Marifas (2014)

**4.0 Tutor- Marked Assignment**

i) Identify and discuss 3 Islamic financial institutions operating with Islamic financial system.
ii) Critically discuss 5 features possessed by Islamic financial institutions.

ii) Examine the multiple roles of Islamic financial institutions relative to the financial services offered.

**5.0 Summary and Conclusion**

In this unit, various factors were discussed to show the disparities in the operations of IFIs and conventional finance and some of the financing modes offered by the two systems.

Islamic financing is working within the Sharia frame work following certain restrictions including the following. First IFIs cannot provide finance for an activity which is prohibited by Sharia (Islamic law) irrespective of its profitability and economic viability e.g. business of liquor, pork and pornography. Second IFIs cannot lend any amount in cash for interest however need is fulfilled either through supply of required asset or through profit and loss sharing. Third under Islamic financial system when financing is provided under profit and loss sharing although profit can be shared as per agreement between the parties involved however loss must be shared according to capital contribution/ownership. Islamic banking is a business very much like conventional banking within certain restrictions imposed by Islamic law. All business needs are being fulfilled by IFIs in efficient ways through Murabaha, Ijara, Bai Muajjal, Bai Salam,

Istasna, Musharaka and Mudaraba. Two features of Islamic financial system are worth mentioning. First is linkage between financial and real sector as IFIs cannot extend credit facility without having support from real sector. Financing is either made through sharing risk and reward or must be asset backed. Second a unique feature of Islamic financial system is in the form of Mudaraba which can play role of catalyst for transforming society into prosperity by extending capital facility to skillful persons lacking capital. More so, its attractive features through ethical values have made it to achieve significant milestone in the global financial transaction.

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## UNIT TWO: ISLAMIC FINANCIAL MARKETS

**1.0 Introduction**

**2.0 Objectives**

**3.0 Main Content**

**3.1 Structure of the Islamic Financial System**

**3.2 Islamic Financial Markets**

**3.3 Types of Islamic Financial Markets**

**4.0 Self-study Questions**

**5.0 Summary and Conclusion**

**6.0 References/Further Readings**

### 1.0 Introduction

This unit presents the structure of Islamic financial system and markets.

### 2.0 Objectives

At the end of this unit, students will be able to learn:

- The components of the Islamic financial system.
- The various types of Islamic financial markets.

### 3.0 Main Content

#### 3.1 Structure of the Islamic Financial System

In this unit, we will discuss the structure of the Islamic financial system is similar to the structure of the conventional financial system. In other words, the Islamic financial system comprises financial institutions (Islamic banks, capital market, Islamic insurance (Takaful) companies, Islamic mutual funds and other finance companies) and markets that bring lenders and borrowers together. Likewise, Islamic financial institutions (IFIs) and markets facilitate the channeling of investable funds from surplus fund units (SFUs) to deficit fund unitst ( DFUs).

However, under the Islamic financial system, Islamic financial markets, institutions and instruments operate in line with Shari'ah rules and principles.

### 3.2 Islamic Financial Markets

Islamic financial markets Up-hold the important role within the Islamic financial system as conduits of funds between SFUs and DFUs within the interest-free realm of Shari’ah, thus distinguishing itself from conventional markets that operate on the basis of interest. As is the case with the conventional' financial system, there are different types of markets within the Islamic financial system: money and capital markets, primary and secondary markets. Nevertheless, emphasis is placed on the broad division of financial markets into money markets and capital markets. Islamic money markets, Islamic capital market (debt markets and equity markets) will be dealt with.

The major instruments of Islamic financial markets are equity related. Besides equity instruments in the form of shares in any company, the Islamic financial system has other redeemable short-, medium- and long-term participating instruments representing ownership in the assets, and hence entitled to participate in the profit/loss resulting from the operations on the assets. Various types of participatory instruments can be based on:

(i) profit/loss sharing (Mudarabah/Musharakah), like instruments issued by Mudarabah and asset management companies and participation term certificates (PTCs), and

(ii) rent-sharing in the form of Diminishing Musharakah or otherwise. Ayub (2007)

The instruments on the basis of which the Islamic market has to function need to be backed by or represent real asset transactions. A debt security would result from a transaction based on any trading or Ijarah mode that can implicitly include time value of money at the stage of pricing of the underlying commodities or usufruct of the assets.

These instruments may be of either a variable or quasi-fixed/fixed return nature. Equity instruments having a claim to share in the net income and the assets of a business give a variable return, while debt-related instruments can be issued in respect of trade or leasing based transactions subject to the observation of the principles of the underlying Islamic modes. Backing by real assets according to the rules of the relevant modes is a must and mere replacement of one paper transaction with another kind of similar paper transaction will not serve the real purpose. Islamic financial market instruments can be of two types in terms of their nature and flow of return:

1. Fixed/quasi-fixed (stable) income securities. A bank can securitize or sell a pool of assets or offer certificates of deposit (CODs) against a fund composed of pooled Ijarah and some Murabaha and Istisna‘a contracts. It will offer the investors/depositors a defined stream of cash flow constituting the return on the pooled assets. Such securities would accommodate risk-averse investors like widows, retired people, etc. and generate newres ources for additional intermediation and income flow to the banks.

2. Variable income (Shirkah-based) securities;for such securities, banks can securitize a pool of Musharakah and Mudarabah contracts that are part of their asset portfolio. Such securities will offer the investors a stream of variable income with potential for growth, based on the strength of the underlying projects – profit and risk both would be higher than in the case of stable income securities. These would accommodate risk-taking investors with the commensurate possibility of a higher income. Ayub (2007)

### 3.2.1 Types of Islamic Financial Markets

As in conventional finance, there are many different types of Islamic financial markets with each market having its own purpose and objectives. Similarly, there are different classifications of these markets. For example, some investors want to invest for a short-term period, while-others want to invest for a long-term period. Some are risk loving, whereas others are risk-averse. Some prefer to borrow through debt market instruments, whereas others prefer to raise funds by issuing stocks. The most common types of financial markets are as follows:

### 3.2.2 Money and Capital Market

Having discussed the nature of Islamic financial markets in terms of returns on the instruments, financial markets can be classified based on the maturity of underlying securities also plays an important role in distinguishing between markets. Short-term debt securities, with a maturity of less than a year, are traded in money markets. On the other hand, debt securities, with a maturity of greater than a year, are traded in capital markets. Similarly, equity securities which are considered long-term securities with no particular maturity are also traded in capital markets.

Hence, the money market is a financial market that facilitates the trade of only short-term debt securities (less than a year), while the capital market is a financial market that facilitates the trade of longer-term debt securities (a year or greater) and equity securities. Furthermore, money market securities are more widely traded and their prices have smaller fluctuations than capital market securities. This implies that the money market securities tend to, be more liquid and represent relatively less risky investments.

Islamic money and capital markets represent an assertion of the Shari'ah principles in the money and capital market transactions where the market should be free from any elements or activities that are prohibited in Islam. The strict adherence to the Shari'ah principles also implies that all financial instruments used by transacting parties in the money and capital markets need to be Islamic in nature.

### 3.2.3 Islamic Money Markets

The money market is the financial market for short-term borrowing and lending, typically for terms of less than a year. This contrasts with the capital market for longer-term funds. In the money markets, banks lend to and borrow from each other using short-term financial instruments.

An Islamic money market is the financial market for short-term financial instruments, typically those operating for less than a year. In the money markets, Islamic banks transfer funds amongst each other. The short-term financial instruments include

Negotiable Islamic Certificates of Deposit (NICD), Government investment issues (GIIs) or other instruments such as Islamic Accepted Bills (IABs) and Islamic treasury Bills (ITBs). Abdul Ghafar (2010))

The objective of the Islamic money market is to provide short-term capital injection to deficit units and at the same time to offer mechanism for investors to place their surplus funds into. The Islamic money market like all financial markets, provide a channel for the exchange of financial assets for money. Therefore, it provides the mechanism through which holders of temporary cash surpluses meet holders of temporary cash deficits.

There are several characteristics of the Islamic money market. Firstly, transaction volumes involve large dominations (involve billions of Naira). Secondly, the Islamic money market has a low default risk. The government tends to provide a safer structural framework for the Islamic money market with proper guidelines such as the guideline of Sell and Buy Back Agreement (SBB) and the guidelines of Islamic Negotiable Instruments (INIs) and laws and procedures to perform transactions between the transacted parties. By doing this, the Islamic money is able to reduce default risks and this form of risk is rarely found in the Islamic money market.

Thirdly, the instruments to be transacted in the Islamic money market have a maturity of less than a year. Therefore, the Islamic money market instruments are usually more widely traded than long term securities because of reasons of liquidity.

Fourthly, the instruments traded in the Islamic money market are shari‘ah compliant. There are no interest elements, but profit rates are allowable, which are fixed in order to reflect shari’ah rulings, and are therefore able to reduce settlement risks. Abdul Ghafar (2010)

The purpose of an Islamic money market is to serve three main functions. Its first function is liquidity management. It serves as an avenue for IFIs to source daily funding or to invest in the short term. Access to money markets enables IFIs to maintain optimal liquidity thereby allowing them to meet the demands of their customers at any time. This therefore, allows the IFIs to cope with short-term pressures. It gives flexibility to the IFIs to face every liquidity situation that might arise due to different timing of cash inflows and outflows. The popular contract, which is used in practice for liquidity management is commodity murabahah which is essentially based on the contract of tawaruq. For non-financial institutions, they use other money market instruments to manage the fluctuations in their working capital needs either by obtaining short-term funding or placement. Consequently, they will be able to enjoy low cost funding or investment returns with low risks.

An Islamic money market also serves as an avenue for secondary trading of money market instruments. Depending on the objectives; risk, and return preferences of money market participants, they will either buy or sell money market instruments in anticipation of obtaining investment returns. The instruments available in the money market provide investors with different levels of risks, returns and maturity. Some of the more popular instruments include the Government Investment Issue (GII), Islamic Treasury Bill (ITB), Islamic Negotiable Instrument (INI) and Negotiable Islamic Debt Certificate (NIDC). Finally, a money market is used as a channel for a central bank to conduct its monetary policy. The mechanism is the same as in the case of the conventional model, i.e .central bank undertakes open market operations by undertaking Repurchase Agreements and reverse Repurchase Agreements (REPOs). In Islamic money markets, this is known as Sale and Buy-back Agreements and Reverse Sale and Buy-back Agreements. ISRA (2011)

### 3.2.4 Components of the Islamic Money Market

The money market has two key components: an interbank money market and a platform for trading money market instruments. Liquidity management is the most important function of Islamic money market. Banks are so dependent on the money market that it is often referred to as the interbank money market. As the name suggests, the interbank money market is a means by which banks borrow and lend among themselves. The necessity for a bank to borrow and lend in the money market arises from the mismatches in daily cash flows from its assets and liabilities. These mismatches can be due to, for example, imbalances between the customer deposits and withdrawals, and the offset balance of the cheque clearing process. Given this, a bank may face cash shortfall or surplus on a daily basis depending on whether withdrawals exceeded deposits or deposits exceeded withdrawals. Since these temporary cash imbalances are of crucial importance and the banks have little influence over the causes of the imbalance, this is where the money market comes to the rescue. The ability to borrow and lend among themselves allow the banks to manage their liquidity efficiently and make the best use of their cash position.

Trading of money market instruments is the second key component of the money market. Just as the interbank money market enables banks to borrow or lend directly among themselves, money market instruments achieve the same objective through the issuance and purchase of different instruments. By using these instruments, banks are able to liquidate their investments to meet their liquidity requirements through secondary market trading. In other words, a money market instrument purchased by a bank today can be sold within the next few days. Hence, the bank would recoup its money without having to wait until the maturity date of the instrument. Therefore, a liquid secondary market for

money market instruments is an essential element which enables the instruments to be traded before their maturity. ISRA (2011)

Likewise, the Islamic money market essentially comprises two components: the Islamic interbank market and the trading of Islamic money market instruments.

Generally, the Islamic interbank market is considered the largest component of any Islamic money market, particularly, its overnight sub-component. An active interbank market is essential in providing signals to the central bank to determine the volume of open market operations (OMO). Central bank use OMO as principal tools for implementing monetary policies.

The Islamic inter-bank funds market can function on the Mudarabah principle or sale and purchase of instruments under the relevant rules of the Sharı´ah. Presently, a Mudarabah based regular market is functioning in Malaysia. In other countries, banks place their surplus funds with deficit banks for short periods ranging from a day to a week. Mostly, theses short-term deposits are treated just like other deposits mobilized from the public and profits are paid on the basis of weightages assigned and the daily product of the deposits, while sometimes a special procedure is adopted, according to which the deficit bank agrees to give a share of its general profits according to a Mudarabah ratio that is negotiated according to the market conditions. Central banks can also advise profit-sharing ratios for the duration of the fund placements. ISRA (2011)

In Malaysia, the Islamic Inter-bank Money Market (IIMM) was introduced in January, 1994 as a short-term intermediary to provide a ready source of short-term investment outlets based on Sharı´ah principles. BNM issued the guidelines on the IIMM in December 1993, to facilitate proper implementation of the IIMM. The IIMM covers the following aspects: (i) inter-bank trading of Islamic financial instruments and (ii) Mudarabah interbank investments (MII). Islamic banks, commercial banks, merchant banks, eligible finance companies and discount houses are allowed to participate in the IIMM.

MII refers to a mechanism whereby a deficit Islamic banking institution ("investee bank") can obtain investment from a surplus Islamic banking institution ("investor bank") based on the Mudarabah principle. The period of investment is from overnight to 12 months, while the rate of return is based on the rate of gross profit before distribution for investments of 1 year of the investee bank. The profit-sharing ratio is negotiable between both parties. The investor bank, at the time of negotiation, does not know what the return will be, as the actual return will be crystallized towards the end of the investment period. The principal invested is repaid at the end of the period, together with a share of the profit arising from use of the fund by the investee bank.

In recent years, Ijarah-based negotiable Islamic money market instruments have also been developed. Islamic banks can engage in trading of these instruments for liquidity

management subject to observance of the Sharı´ah rules involved in the relevant modes. Ayub, (2007).

### 3.2.5 Islamic Money Market Participants

The main participants in the money markets are banks, non-bank financial institutions such as takaful and insurance companies, business corporations, the government treasury and the central bank. Banks use the Islamic money market for liquidity management purposes, especially to adjust the mismatch of assets and liabilities in their statement of financial position. They can use the money market to obtain short-term liquidity or to place their short-term surplus funds over a limited period. They can also buy money market instruments such as treasury bills to invest their surplus funds for a short term, or sell their holdings of these instruments to raise funds.

Business corporations as well as government agencies also use the money market for short-term investments. Likewise, large business corporations by virtue of their high credit rating, source short-term funds by issuing commercial papers. The central bank, as the regulator which promotes market stability, uses the money market as a channel to transmit its monetary policy. One such example is the use of open market operations as a means of influencing the liquidity level and short-term interest rates in the domestic financial system. Open market operations refer to the act of buying and selling of government securities by the central bank to influence liquidity and interest rates in the financial system. Changes to the level of liquidity and short-term interest rates in the money market will affect long-term rates in the financial system. The government, another important player in the money market, uses the money market as a source of short-term funding via the issuance of securities. ISRA

### 3.2.6 Islamic Capital Market

The Islamic Capital Market (ICM) refers to the market that provide long term investment funds through various financial instruments that meet the holder’s needs. In this market, activities are carried out in ways which do not conflict with the principles of Islam. The ICM transactions must be free from prohibited activities and elements such as riba, maisir and gharar.

Islamic Capital Markets broadly comprised three main segments:

1. The Islamic equities market (facilitated by Shariah-compliant indices availability)
2. The Sukuk or Islamic bond market
3. The Islamic funds market ( 2015 *IFSB Financial Services Industry Stability Report)*

An Islamic capital market, as is the case of a conventional capital market, constitutes an integral part of the Islamic financial system. In general, an Islamic capital market

comprises two main components: the debt market and the equity market. They are indispensable for the efficient mobilization of resources and their optimal allocation. While generally being similar to conventional capital markets, Islamic capital markets differ in their core elements which are deeply rooted in Shari'ah teachings. As a result, Islamic capital markets offer instruments, such as Islamic equity securities and Islamic debt (bond) securities, among others, based on the Shari'ah principles that make them compliant. Islamic capital markets play a complementary role to the investment role of Islamic banking thus creating a comprehensive Islamic financial system.

The growing awareness of and demand for investment in Shari'ah-compliant products and instruments around the globe has resulted in the creation of a flourishing Islamic capital market. Today, there are a number of Islamic capital market products and services, such as sukuk, Islamic stocks, Islamic bonds, Islamic funds, Islamic real estate investment trust (REIT).

### 3.2.7 Debt and Equity Markets

There are two ways for firms or government agencies to raise funds, in a financial market: by issuing debt securities (bonds) or, equity securities (stocks). Issuing a debt instrument is the most common method of raising funds. This, debt instrument represents a contractual agreement whereby the borrower is obliged to pay the holder of the instrument a certain fixed amount of money at agreed intervals. The return to investors is in the form of interest income (coupon payments). Upon maturity, the principal amount will be paid to the investors. Depending on the maturity, a debt instrument can be a short-term instrument if its maturity is less than a year, intermediate-term instrument if its maturity is between one and 10 years, or long-term instrument if its maturity is 10 years or longer. Long-term debt instruments tend to bear more risk and are expected to yield a higher expected return than short- term instruments.

Essentially, the interest or coupon payments embedded in debt instruments like bonds clearly violate the Shari'ah principles. Under Shari'ah, loan contracts must always be interest-free. Any additional benefit to the lender in a loan contract either monetary or, in kind is deemed as a form of riba , which is prohibited in Shari'ah.

Alternatively, debt securities in Islamic debt market is structured based on Islamic debt certificates like sukuk which actually resembles the features of conventional bonds representing debt or borrowed funds by the issuer.

Recently IFIs have created an avenue to meet their liquidity requirement in the form of Sukuks (Islamic Bonds) whereby servicing is fixed like conventional bonds however such types of Sukuks can be issued against Ijara receivables. Under Ijara Sukuks initially asset is given on rent to the customer for an agreed period and rentals while ownership remains with IFI. To meet liquidity requirements IFI issues Sukuks (bonds) to the investors equal to the value of asset, hence ownership of the asset is transferred to Sukukholders. While it is known the rentals of

the asset on the return on investment is predetermined and known with certainty to the investors. Skuks of Murabaha cannot be sold except at par being sale of loans. Other types of Sukuks (Musharaka etc) are not carrying fixed return although tradable in secondary security market. Underlying principle in issue of Sukuks is that illiquid assets should dominate in the portfolio against which Sukuks are issued. Under Islamic financial system Sukuks are ownership certificates and not mere debt securities hence all risks and rewards are shared by Sukukholders. Ayub(2007)

The other way of raising funds for firms and government agencies is through the equity market by issuing equity securities, (stocks). Equity securities differ from debt securities in that the former represent partial ownership in the issuing entity while the latter have no such right. Furthermore, equity securities tend to be riskier than most long-term debt instruments, but they also tend to have a higher expected return as well. Holding equity securities of any corporation has its own advantages and disadvantages. As the corporation grows and its value increases, holders of its stocks can earn a. return from periodic dividends and a capital gain if they sell stocks. Holders of its stocks, however, can experience a negative return as well if the corporation performs poorly and if the stock price declines over time.

In Islamic equity market, equity instruments must be structured based on the permissible rules and principles stipulated in, Shari'ah. Moreover, since stocks represent undivided shares in the capital of a corporation, it is vital to ensure that the business activities of the corporations do not involve Shari'ah-prohibited and unethical activities such as gambling, selling of alcohol, pornography, violating human rights, environmental degradation, tobacco manufacturing and riba-based business activities.

Listing here the major conditions to qualify a security as Sharia compliant is worth mentioning as meeting of the following tests is required to declare a security as Sharia compliant (KMI-2008).

First the core business of the company should be Halal (not prohibited by Islamic Law such as liquor, pork and pornography etc). Second illiquid assets should be equal to 20% of total assets of the company. Shares of a company merely dealing in liquid assets are not Sharia compliant hence IFIs cannot invest. Third ratio of all interest based debts including preferred stock should be less than 40% of total assets of the company. Fourth ratio of non-Shari'ah compliant investments to total assets of the company should be less than 33%. Fifth revenue from non-compliant investments should be less than 5% of total revenue of the company and even then IFIs are required to purify their earnings by spending this non-compliant revenue as charity. Finally market price per share should be greater than the net liquid assets per share. Ayub(2007)

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### 3.2.3 Primary and Secondary Markets

Whether we are dealing with short-term debt securities that are traded on money markets or longer-term debt and equity securities that are traded on capital markets, it is important

to differentiate between the initial trade of securities and their subsequent resale on markets.

Corporations and government agencies use a primary market to raise funds from initial buyers of a security, such as a bond or a stock. A secondary market is a financial market where existing securities are bought and sold.

Thus, an initial sale of a bond or a stock is a primary market transaction and with this transaction, the initial issuer of a security raises the funds. On the contrary, the sale of an existing bond or a stock is a secondary market transaction and this transaction does not provide funds to the initial issuer. Nevertheless, secondary markets play important roles in the overall financial system. First, it provides liquidity which represents a degree to which securities can be easily-liquidated (sold) to raise cash. If a security is highly liquid, meaning that there are many willing buyers and sellers of the security, it means that its holder can easily sell it for cash without a loss in value. A holder of an illiquid security, on the other hand, may need to offer a large discount to a buyer, thus, losing value. Secondly, secondary markets provide necessary information to both savers and borrowers by determining the price of securities. The higher the price of a given security in secondary markets, the more funds can be raised by the issuing corporation in the primary markets.

Promoting vibrant and efficient secondary markets for Islamic finance remains one of the most challenging aspects of the Islamic financial system. This is due to the limited number of Islamic financial instruments and structures which qualify for secondary trading, especially debt-based securities. The issue of debt-trading or bay' al-dayn has always been a point of contention among past and present Islamic jurists. The contentious aspect of debt-trading is whether the debt can be traded to a third party at a discounted value.

The primary markets operate on the basis of equity principles like shares, redeemable equity capital, Mudarabah/Musharakah certificates (MCs) or Sukuk representing ownership in leased assets or debt instruments resulting from trading modes issued directly to investors or fund providers. While the price of Sukuk in the primary market is derived through calculating the weighted average of the bids received for the premium to be offered over the benchmark, the price in secondary market trading depends upon the nature of the security being traded.

According to mainstream Islamic finance theory, pure debt securities do not have a secondary market in principle. However, there is the possibility of securitization of debts resulting from real trading transactions when they are pooled with other assets or instruments representing ownership in real assets. All equity or participatory instruments have a secondary market because they represent ownership in assets of the companies. Ayub,(2007)

### 3.2.4 Trading in Financial Instruments

Islamic investment vehicles that are traded in Islamic financial markets include Sharı´ah compliant stocks wherein income is derived from dividends and capital gains keeping in mind the screening criteria recommended by Shari´ah scholars. Other instruments are Mudarabah/Musharakah certificates, units of open- or closed-ended mutual funds and investment
Sukuk; wherein income is derived from buying, selling and also getting returns from the underlying businesses and assets. Stocks/securities/certificates/Sukuk can be traded in the market depending on market signals, provided there is compliance with the following Sharı´ah rules:

• Instruments representing real physical assets and usufructs are negotiable at market prices.

Certificates or Sukuk issued by Musharakah, Mudarabah and Ijarah are covered under this category.

• Instruments representing debts and money are subject for their negotiability to the rules of Hawalah (assignment of debt) and Bai'al Sarf (exchange of monetary units).

• Instruments representing a pool of different categories are subject to the rules relating to the dominant category. If cash and debts/receivables are relatively larger, the rule of Bai'al Sarf applies, and if real/physical assets and usufructs are overwhelming, trading would
be based on the market price. AAOIFI, 2004–5a, pp.

## 3.3 ISLAMIC VS CONVENTIONAL FINANCIAL SYSTEM

### 3.3.1 Comparison between Islamic and Conventional Financial System

Islamic Financial Institutions (IFIs) are operating in the same society where conventional banks are operating and perform all those functions which are expected from a financial institution. IFIs are assisting business world by providing all the services required to run the economy smoothly, however, the philosophy and operations are different. In this unit, the operations and products of IFIs in comparison with traditional conventional banks will be analyzed. Any financial system is expected to assist in running the economy by providing the following services grouped in two headings. First; Savings mobilization from savers to entrepreneurs and Second; Provision of general utility services including transfer of funds, facilitation in international trades, consultancy services, safekeeping of valuables, and any other service for a fee. There is no restriction on provision of such services by IFIs as for the service is not against the Shari'ah. However there exists difference in mechanism of funds mobilization from savers to ntrepreneurs as described following savings mobilization consists of two phases i.e. Accepting deposits and extending financing and investments. Abdul Azeez (2015)

### 3.3.1 Deposits

Deposits are collected from savers under both type of institutions for reward irrespective a bank is operating under conventional system or Islamic system. The difference lies in agreement of reward. Under conventional system reward is fixed and predetermined while under Islamic deposits are accepted through Musharaka and Mudaraba where

reward is variable. Under conventional banking return is higher on long-term deposits and lower for short-term deposits. Same is the practice in Islamic banking to share profit with depositors. Higher weight for profit sharing is assigned to long-term deposits being available to bank for investing in longer term
projects yielding superior returns and lower weight for short-term deposits which cannot be invested in long term projects. The only difference in conventional and Islamic system lies in sharing of risk and reward. Under conventional system total risk is born by the bank and total reward belongs to it after servicing the depositors at fixed rate while under Islamic system risk and reward both are shared with depositors. Reward of depositors is linked with outcomes of investments made by IFIs. Under Islamic financial system only those IFIs will be able to collect deposits who can establish trust in the eyes of masses hence leading to optimal performance by financial industry. (SBP,2010)

### 3.3.2 Financing and Investments

The second phase in savings mobilization process is extension of credit facility to business and industry for return. Both types of institutions (Islamic and Conventional) are providing financing to productive channels for reward. The difference lies in financing agreement. Conventional banks are offering loan for a fixed reward while IFIs cannot do that because they cannot charge interest. IFIs can charge profit on investments but not interest on loans. In conventional banking three types of loans are issued to clients including short term loans, overdrafts and long-term loans. Islamic banks cannot issue loans except interest free loans (Qard Hasna) for any requirement however they can do business by providing the required asset to client. The comparative working of different products (financing scheme) of both systems will be presented below

### 3.3.3 Overdrafts/Credit Cards etc.

Conventional banks offer the facility of overdrawing from account of the customer on interest. One of its form is use of credit card whereby limit of overdrawing for customer is set by the bank. Credit card provides dual facility to customer including financing as well as facility of plastic money whereby customer can meet his requirement without carrying cash. As for facility of financing is concerned that is not offered by Islamic banks except in the form of Murabaha (which means IFI shall deliver the desired commodity and not the cash) however facility to meet requirement is provided through debit card whereby a customer can use his card if his account carries credit balance. Under conventional banking a customer is charged with interest once the facility availed however under Murabaha only profit is due when the commodity is delivered to the customer. Furthermore in case of default customer is charged with further interest for the extra period under conventional system however extra charging is not allowed under Murabaha.

Under conventional system customer can avail the opportunity of rescheduling by entering into a new agreement to pay interest for extended period which is not the case under Murabaha. IFIs can claim only the original receivable amount agreed in initial contract. Another practical issue under Murabaha is how to deal with intentional defaulters. Different options are lying with IFIs including to blacklist the defaulter for any further financing facility, to stipulate in the contract that in case of default all

installments will be due at once, to stipulate in the contract a penalty shall be imposed but the same shall not form income of IFIs rather it will go in charity
(Usmani, 2002).

### 3.3.4. Short term loans

Short term and medium term loans are provided to customer to meet working capital requirements of firm by conventional banks. Working capital is required by firms to invest in inventories and accounts receivables and meet the expenses. As for inventory investment is concerned that is provided by Islamic banks through Murabaha. As for meeting of day to day expenses of business is concerned financing is provided through participation term certificates where by profit of a certain period (e.g. quarter, six month, one year) is shared by IFIs on prorate basis. However financing through participation term certificates is not as easy as a short term loan from conventional bank due to risk involved for IFIs in the transaction. Firm seeking short-term facility from IFIs has to prove the viability of the project/business to the satisfaction of investor. For meeting the working capital requirements of nonprofit organizations to date there is no arrangement under Islamic financial system. Personal consumption loans are also not issued by IFIs however any individual of sound financial position can acquire anything for his personal use under Murabaha financing whereby a certain percentage of profit is added on cost by IFIs. Murabaha financing is very useful for short to medium term financial requirements of business/nonprofit organizations and individuals. Murabaha financing is asset based financing and anyone can request to an IFI for provision of an asset generally used for Halal (lawful) purposes. By default under Islamic financial system IFIs cannot lend cash for interest (only exception is Qard - Hassan—Charity loan). One of the features of Murabaha is in case of delay in payment by customer IFI cannot ask for extra amount as time value of money like conventional banks. However penalty is imposed on defaulter if stipulated in original contract of Murabaha duly signed by the customer but same cannot be included in the income of IFI. This penalty must be spent for charitable purposes. Under Murabaha scheme of financing facility is linked with assets which leads to economic stability and creates linkage between real and financial sector.

It is not zero sum game because utility is created through services and products and not by mere building the blocks of wealth through dealing in paper money. Although Murabaha is being used by IFIs successfully and have succeeded in meeting short to medium term requirements of firms by providing a successful replacement of conventional loans yet certain differences exist in both type of financing. First is one cannot get cash under Murabaha. Second asset is purchased by IFI initially then transferred to customer hence IFI participate in risk. Third refinancing facility is not available under Murabaha. Fourth in case of default price of the commodity cannot be enhanced however penalty may be imposed if stipulated in original contract of Murabaha however same cannot be included in income of IFI. Fifth only those assets can be supplied by IFIs under Murabaha whose general and/or intended use is not against the injunctions of Sharia (e.g. supply of a machine to produce liquor). SBP (2014)

### 3.3.5. Medium to long term loans

Medium to long-term loans are provided for purchase or building of fixed assets by firms to expand or replace the existing assets. Under Islamic financial system requirement of firms and individuals are fulfilled through Murabaha, Bai Muajjal and Istasna. Another financing option for long-term financing is profit sharing under Musharaka and Mudaraba . Although financing under Murabaha, Bai Muajjal and Istasna is very much look like conventional loans with the only difference of provision of asset and not cash to client however differences exist in the contracts which alter the nature of risks and returns. Financing under Musharaka and Mudaraba is challenging for IFIs and firms as well. Under Sharia based financing schemes firms have to prove the viability/profitability of the project/business to the satisfaction of IFIs to get the finance because risk of losing the amount is involved.

### 3.3.6. Leasing

Leasing is relatively recent source of financing whereby usufruct of an asset is transferred to lessee for agreed amounts of rentals. Under leasing ownership may or may not be transferred

Same facility is provided by IFIs under agreement of Ijara. Under Ijara asset is provided to customer for use with out transfer of ownership for a specific period of time in exchange for agreed rentals. Ownership of asset can be transferred to customer through mutual agreement at the completion of lease term. All ownership risks are born by IFIs during Ijara tenure. Certain differences exist in the transaction under both systems. First is rental under Ijara are not due until asset is delivered to the lessee for use. Second additional rent cannot be demanded in case
of default except a penalty (if stipulated in original contract of lease) which is not the income of IFI. Third during period of major repair rent cannot be demanded by IFI. Fourth if asset is lost or destroyed IFI cannot claim further installments hence all risks of ownership are born by IFI.

### 3.3.7. Agricultural Loans

Agricultural loans include both types of loans short-term as well as long-term. Short-term loans are required by farmers for seeds and fertilizers and long-term loans are required to develop additional lands and purchase of equipment. Normally farmers return these loans after selling the finished crops. Conventional banks are providing credit facility by charging interest. Same facility is provided by IFIs to the farmers under Bai Salam, Bai Murabaha Musharaka and Mudaraba  Under Bai Salam cash is provided to farmers for purchase of seeds and fertilizers however this is not loan rather purchase of finished crops to be delivered by farmers. For purchase of equipments Murabaha facility is used and for development of additional land Musharaka and Mudaraba is used by IFIs. To get finance for land development farmers have to convince the IFIs about profitability of the venture due to risk involved in the transaction.

### 3.3.8. House financing

Housing finance/Mortgages is the more secured form of financing for both conventional banks and IFIs. Under conventional system loan is provided for interest while under Islamic financial system facility is provided through diminishing Musharaka. Under diminishing Musharaka house is purchased jointly by IFI and customer. IFI rents out its share in property to customer for an agreed amount of rent. Share of financier is divided in units of small denomination. Customer pays the installments to IFI consist of rentals plus purchase price of a unit. Stake of customer in property is increasing while of IFI is decreasing with payment of every installment. Finally with the payment of last installment stake of IFI reaches to zero and property is transferred in the name of customer. Diminishing Musharaka model can help out in avoiding the real estate crisis (of 2008) because when market value of property decreases both IFI and customer suffers according to their share in property and whole burden is not shifted on customer alone.

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### 3.3.9. Investments

In order to maintain liquidity conventional banks have many avenues including government securities, shorter term loans and money at call and short notices, leasing companies' bonds, investment in shares etc. Interestingly mandatory reserve maintenance by conventional banks with central banks is also rewarded in the form of interest. Conventional banks can also create liquidity by issuing the bonds against their receivables. Commercial banks are also protected by central bank by providing liquidity in rainy days for interest. Interbank deposits are also rewarded in the form of interest by commercial banks. For IFIs avenues are very limited to create required liquidity at the same time to earn some revenue by investing in short term and liquid securities. IFIs cannot invest in government securities, short term loans, bonds and money at call and short notices because of interest based transactions. Mandatory reserve with central bank is maintained by IFIs but they are not rewarded like conventional banks.

Looking towards central bank in rainy days to maintain liquidity is also not as straightforward due to interest demand of central bank. IFIs cannot demand interest on interbank deposits. As for investment in marketable securities are concerned; IFIs are not free to invest in any equity security due to two reasons. First Halal business of the underlying firm is required. Second financial operations of underlying firm should be interest free.

Keeping in view the dominance of conventional banking and existing business practices one can conclude safely that a very negligible number of firms meet both conditions.

### 3.3.10 The usage of money

Islamic finance compared with conventional finance does not, and should not, deal with money directly as money cannot create more money by itself. Money must be put into real business activities to earn extra money. This is the whole basis of trading. In other words, IFIs facilitate the financing needs of customers by becoming sellers, lessors or partners as the case may be. The function of money has been transformed from a commodity into an enabler to facilitate trading, leasing and investment. The pool of

money, collected through various Islamic accounts and/or shareholders' funds, is channeled to finance trade, lease or investment activities. From a macro perspective, the money has been transferred into real economic sector in order to generate more income. Thus, the profit generated by IFIs is the outcome of dealing with a real asset rather than a monetary asset. Muhammad H (2011)

### 3.3.11 Shari'ah compliance and the equity market

The distinction between Islamic finance and conventional finance is more obvious in banking and insurance products as well as in fixed income instruments than it is in the equity market. Conventional banking and fixed income instruments are essentially based on interest, while the conventional insurance contract is based on the sale of an indemnity for a premium that contains a considerable degree of uncertainty. There is no Shari'ah issue on the contract of investment in the equity market as it is essentially based on the principle of profit and loss sharing. In other words, buying a share in any stock exchange is permissible as this purchase reflects a contract of Musharakah among the shareholders. This contract, per se, is compliant.

However, Shari'ah objections are mainly concerned with the activities of the companies in which the capital, through subscription to the shares, is put. These activities may include the sale or purchase of assets and services that are not approved under Shari'ah principles such as the sale or purchase of non-Halal food and drink. Non-approved activities also include activities related to the balance sheet of the company such as the borrowing or raising of more capital through interest-based transactions such as overdrafts and conventional bonds. Ayub (2007)

## 4.0 Self-Assessment Questions

- List and explain the various types of Islamic financial markets you know.
- Give the important functions of Islamic money market to Islamic financial institutions.
- List And explain Islamic capital market instruments

## 5.0 Summary and Conclusion

It can be observed that Islamic financial system functions similar to the conventional finance in terms of mobilization and allocation of resources from the surplus funds unit to the deficit fund units. It consists of financial intermediaries such as financial institutions, financial markets, financial instruments and the

regulatory institutions. From the discussions above, we can deduce that all the components of the Islamic financial system function to give the system a shape and character thereby enhancing the distribution of resources among the ultimate users.

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## UNIT THREE: ISLAMIC FINANCIAL INSTRUMENTS

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### 1.0 Introduction

This unit will enlighten us on the meaning, nature and uses of Islamic financial instruments. Islamic financial instruments are transacted using Shari'ah contracts mostly based on the profit and loss sharing principle, operational mechanisms of the instruments will also be explained.

### 2.0 Objectives

At the end of this unit, students will be able to understand:

- The nature of the Islamic financial instruments
- The uses of the financial instruments

### 3.0 Main Content

#### 3.1 Meaning and Nature of Islamic Financial Instruments

A financial instrument is a by-product of a contracting party. A financial instrument obligates one party to transfer something, usually money, to another party. By party, we mean an individual, firm or government. Usually the financial instruments specify the rights and obligations of the contracting party. The specification will be clearly written in the contract.

A contract ('aqd) is referred to as an obligation which arises from a bilateral relationship between two parties. It is however defined as the conjunction of an offer emanating from one of the parties with an acceptance of the other in relation to the subject matter of the contract.
In the Quran Allah says:

In the Quran Allah says: **"**O you who believe! Fulfill (your) obligations**" (**Al Quran 05:01**).** This verse of the Quran forms the legal basis for a contract in Islam.

A contract is known as Aqd in Arabic which means 'to tie' or 'to knot' or 'to join'. Legally, a contract binds all the parties involved in it. Due to the fact that a contract expresses the intention of the parties and establishes their rights and liabilities, it also clearly defines the nature, parties, processes, means and duration of a transaction or business. Marifas (2014)

For a contract to be valid in Shari'ah, certain conditions must be met. There are three elements of a valid contract:

--The form of the contract (sighah); which comprises of the offer (ijab) and acceptance (qabul).

-The contracting parties (al-qidayn) and

- The subject matter (al-ma'qud 'alayh) i.e the commodities to be transacted.

All contracts in Islamic finance are structured in the light of Shariah principles**.**

### 3.1 Characteristics of Islamic Financial Instruments

Economic activities within a financial system are performed by different economic agents who, more often than not, come into contractual relationship with other agents in pursuing their economic activities. This contractual relationship is usually defined through a financial instrument which is seen as a contract with terms, conditions, risk and return profiles defined.

a) The creditor-debtor relationship is the feature of commercial financial contracts based on interest, where interest is seen as both the price of an underlying product or credit and cost of money. However, paying and charging interest is against the principles of Shari'ah and thus cannot be used within the Islamic financial system. As pointed out earlier, Islamic financial institutions channel funds from SFUs to DFUs and provide risk-sharing, liquidity, and information to market players. All of this is done through various financial instruments.
b) While conventional financial intermediation is done through instruments that are interest-based-, Islamic financial intermediation and instruments must be free from prohibited elements. From the Shari'ah point of view, every contract is considered to be legal and lawful as long as it does not go against any prohibited elements, such as riba, gharar and maysir. However, investing in companies that are free

from these elements, but are producing alcohol, tobacco and pork is not allowed since alcohol, tobacco and pork are not allowed (halal) in Islam as well.

c) Islamic financial instruments serve as alternative products for most products offered by conventional financial institutions. However, while they are similar in nature and functions performed, the Islamic financial intermediation differs significantly when it comes to the underlying contracts and mechanisms used. In fact, it is due to these underlying contracts that distinguish the Islamic mode of intermediation from the conventional one. For example: an IFI, in this case an Islamic bank, can use several contracts for the mobilization of funds. In particular, it can use contracts such as mudarabah, and wadi'ah for the mobilization of funds. While what Islamic banks have at their disposal is relatively small number of contracts/instruments for the mobilization of funds, they have a greater spectrum of instruments for the utilization and investment of funds. Each and every contract has its own features and characteristics that affect the nature of contractual relationship between the parties involved. In short, although Islamic financial instruments may look like a mirror picture of conventional ones, their underlying features, contractual relationships, mechanisms and implications are not identical.

d) There are mainly two approaches to developing modern Islamic financial instruments, namely an adaptive and innovative approach. Under the first approach, existing conventional instruments that are generally acceptable from the Shari'ah point of view are modified and further enhanced by removing any prohibited elements that may hinder validity of the instrument. On the other hand, Shari 'ah scholars are actively involved in searching for new and innovative instruments that are based on various Shari'ah contracts mentioned previously. Abdul Ghafar (2010)
e) Islamic financial instruments are used in transaction to enhance asset acquisition (asset-backed) through trading to earn a return unlike the conventional finance, the basic instrument of transaction is debt based on interest rate.

### 3.2 Uses of Islamic Financial Instruments

Islamic financial instruments are generally used for similar purposes as their conventional counterparts. The fundamental difference between the two types of financial instruments is the underlying Shari 'ah-compliance applicable to Islamic financial products. Islamic bank can use contracts such as mudarabah, wakalah and wadi'ah for the mobilization of funds. In the case of mudarabah, a depositor acts as rabbul mal and the Islamic bank as

mudarib. Shari'ah scholars have also allowed certain freedom to the mudarib who is allowed to form partnership(s) with third parties. This model is known as the two-tier mudarabah, which is also the basis for modern Islamic banking. In the case of wakalah, which means representation, an agent (wakil) acts on behalf of the principal. The difference between mudarabah and agency (wakalah) is in the freedom and control of funds by the agent. The mudarib (manager of mudarabah) has full control and freedom to use the funds provided by the capital supplier (rabbul mal), while the agent (wakil) has limited freedom as he acts only in accordance with instructions given to him. Finally, deposits placed under the principle of deposit (wadi'ah) are considered as a trust with a trustee, a bank, for safe-keeping. The depositor allows the bank to utilize his funds without expecting any returns. However, since these deposits are placed for safe-keeping, the trustee is obliged to return them to the depositor upon demand. Abdul Ghafar(2010)
We can use financial instruments as investments, as a means of payment and as a store of values.

a) As investment; Provision of capital itself is a form of an investment (for rabb al-mal) and can be used as investment in the form of mudarabah which is considered a special form of partnership, that has been deployed Aby modern Islamic financial institutions to provide fund management services.In line with the Islamic principles of risk-sharing and profit-sharing. It is characterized by one party (rabbal-mal) entrusting his money to another party (mudarib) who is akin to fund manager and who contributes to the arrangement by providing the necessary experience and management expertise. The mudarib will utilize the money in an agreed manner, and will subsequently return the principal and a share of the profit to the rabb al-mal without retaining a pre-agreed share of the profit for him.

The important principles to note is the division of profits must be on a pre-agreed proportional basis; if a loss occurs then the rabb al-mal will not usually face liability beyond the loss of his time and effort. Mudarabah may be entered into for a single investment or on a continuing basis with the Islamic banks acting as a fiduciary. Mudarabah investment may be made for fixed terms and arranged through negotiable instruments and in such situations may have characteristics akin to shares.

b) The uses of financial instrument as a means of payments can be seen from the following explanation. For example Islamic banks act as agent (wakeel) and hence receive fee payments. The common meaning of the word “payment” is “the action, or an act, of paying the remuneration of a person with money or its equivalent; the giving of money etc . The word is also defined as a sum of money (or other things) paid; pay wages or price. Thus, the word payment often connoted an exchange of value for the

provision of goods or services, or the provision of value on the occasion of a particular event or condition.

c) A financial instrument can be used as a store of value; this means that it is an asset and can be exchanged for other goods or service over time. Any form of commodity, asset, or money that has value and can be stored and retrieve over time. Possessing a store of value is an underlying basis for the Islamic economic system as some medium is necessary for a store of value in order for individuals to engage in the exchange of goods and services. What is considered a store of value can be markedly different from one region of the world to another .In fact, any physical asset can be considered a store of value under the right circumstances, or when a base level of demand is believed to exist. Abdul Ghafar (2010)

d) It is used by IFIs to manage liquidity as the nature of their transactions requires them to be liquid at all times. Also, enable IFIs to actively observe certain regulatory provisions in terms of reserve ratio and liquidity assets as requirements to fulfill operational status.

e) They (financial instruments) are used by government, corporate bodies to finance development projects e.g sukuk

f) On the assets side, various contracts are used for many purposes. The most widely used contract is murabahah' which refers to cost-plus sale, whereby a financial institution buys a product such as commodity, equipment and raw materials, and 'sells it to a client who could be an entrepreneur. The price of the goods sold is equal to the cost of the goods plus a profit margin agreed by both parties. The payment is usually delayed to a future date and it can be made either in lump-sum or by instalments. Hence, this instrument can be used for providing short-term working capital or as a letter of credit for financing export-import related trade financing.

g) Islamic financial instruments are also used for fund management services. In this case, for example, mudarabah and musharakah can be used. In the case of mudarabah, the capital provided by participants (rabbul mal) will be entrusted to a mudarib or a fund manager who will manage the fund according to his expertise without undue interference of the rabbul mal. The profit realized at the end of the period will be shared between capital providers and the fund manager according to the agreed profit-sharing ratio. In the case of musharakah, however, the fund manager will also contribute capital to the fund, thus making him a partner. The difference between the mudarabah and musharakah models lies in the way the loss is treated. Under the musharakah model, the loss is to be shared according to the capital invested, while in the case of mudarabah, the loss is completely borne by

rabbul mal, unless it is proven that the loss is due to the fund manager's negligence. Ayub (2007)

### 3.4 Applications of the Islamic Financial Instruments in IFIs

In our previous discussion, we have various Islamic financial instruments and their uses, now we are going to explore the applications of these instruments in transaction by the participants in IFIs.

Various funds can be established to finance the economic activities of public and private enterprises on equity, partnership, leasing, Salam and mixed asset pool bases. Funds can be established to finance a specific sector, for example, agriculture, industry or infrastructure; a particular industry, for example textiles, household durables, etc.; or general types of projects.

#### 3.4.1 Financial Instruments Offered by Islamic Banks

Discussing the financial instruments offered by banks, we deal with their funding, their sources of funds. Islamic banks of course have to follow the precepts of Islamic finance. This implies that not only their lending but also their funding should make use of lawful financial instruments. Islamic banks are thus free to issue shares, but not conventional interest-bearing debt. In principle they offer instruments that pay a variable return, depending on the return on their assets. In this respect deposits with Islamic banks would resemble investment funds. In actual practice, deposits usually offer a much more stable return. We start with an enumeration of the different financial instruments offered by Islamic banks in order to fund themselves and follow this up with a brief discussion of the various instruments.

Apart from share capital, Islamic banks attract funds by issuing or selling the following instruments:

- Iinvestment or PLS (profi t-and-loss sharing) accounts
- Savings accounts
- Transaction accounts, or current accounts
- *Quard hasan* accounts
- Borrowings

**A. Investment or PLS accounts**

Investment or PLS accounts are in principle meant as mudaraba funds, with the depositor acting as rabb al-mal, or fi nancier, and the bank as mudarib.1 If losses occur, these should be borne by the depositors. In practice, however, clients are not expected to share in any losses of the bank;

in general there is a de facto guarantee on the capital sum of deposits. This of course is at variance with the principle that the mudarib, in this case the bank, should not shoulder any losses, but the forces of competition do not leave the banks much choice. A common practice is the smoothing of profit disbursements over time through a profit equalization reserve into which

a part of a bank's profits is paid. This enables the bank to avoid low profit disbursements to its depositors in lean years, or to increase profit disbursements in order to stay competitive if conventional banks increase interest rates on deposits (Wilson 2007).

**B. Savings accounts**

Islamic banks can offer savings accounts guaranteeing the nominal value of the savings deposits and even providing a return. The guarantee can be given because of the legal fi ction that the client's money is placed with the bank in custody, *amanah*, or safekeeping, *wadia* (Errico and Farahbaksh 1998; Sundararajan et al. 1998). Ideally, the money should be held by the bank in the form of cash and not be re-lent, but that does not seem to be the way the banks handle these accounts. The banks of course are not allowed to pay interest on these deposits, but anybody is free to bestow gifts on anybody else, and banks are no exception. They thus may pay depositors a gift, *hiba*, depending on their profitability. This is not a form of interest, or riba, because there is no promise of a predetermined payment.

**C. Transaction accounts or current accounts**

Transaction or current accounts pay no interest, but the nominal value of deposits is offi cially guaranteed. Again, this is under the fl ag of amanah or wadi'a. In cases where conventional banks might pay interest, Islamic banks can off er free services Overdrafts are not allowed, and if it proves impossible to intercept an electronic payment and a negative balance ensues, the bank will not demand interest but charge a fixed fee.

**D. Quard hasan accounts**

Quard hasan accounts pay no interest and are meant to provide funds that the bank in its turn uses to grant quard hasan loans.

**E. Borrowings**

Conventional banks hardly ever do without fixed-income liabilities. The closest Islamic equivalents are surely sukuk, and Islamic banks are starting the usage of these for their own funding. The pioneer was Malaysian Banking Berhad (Maybank), which issued a $300 million (RM 1.03 billion) subordinated Sukuk in 2006 in order to strengthen the tier 2 capital of the bank. Hans (2009).

### 3.4.2 Instruments on the Assets Side (financing)

Islamic banks' financing practice as of now reveals that the doors are open for utilizing all legitimate modes including those based on Shirkah (partnership), trade or lease, whether to finance trade, industry or a budget deficit through domestic or foreign sources. In order to properly manage the risk, the banks should manage diversified portfolios and select the proper modes/instruments. The volume of investment deposits determines banks' investment strategies – if depositors are risk-averse, banks should also be risk-averse – investing in less risky modes.

Musharakah/Mudarabah can be used for short-, medium- and long-term project financing, import financing, preshipment export financing, and working- capital financing and financing all single transactions. Banks use Diminishing Musharakah for purchase of fixed assets like houses, transport, machinery, etc.

Murabaha can be used for the purchase and sale of automobiles, consumer durables and trade financing, acquisition and holding of stock and inventory, spares and replacements, raw material and semi-finished goods. Buy-back and rollover in Murabaha are not allowed.

Musawamah can be used for the financing of huge single transactions.
Salam has a vast potential in financing the productive activities in crucial sectors, particularly agriculture, agro-based industries and the rural economy as a whole for financing agriculturists/farmers, commodity operations of public and private sectors and other purchases of homogeneous goods.

Banks' subsidiaries as trading and leasing companies can also provide finance on the basis of Murabaha and leasing. They can deal with priority areas not only on the basis of Murabaha, Salam and operating lease; also on the basis of partnership. Ijarah, or leasing, is best suited for financing of automobiles and machinery. There could also be a combination of more than one mode like Istisna'a plus Murabaha, Salam plus Murabaha or Salam plus Istisna'a for financing of trade and industry. Finance for the purchase and construction of houses can be based on Diminishing Musharakah or Murabaha. Working capital finance can be provided on the basis of Salam, Istisna'a and Murabaha. Financing of big projects can be made through syndicate Mudarabahs using the modes of Istisna'a or Murabaha. Ayub (2010)

### 3.4.3 Fee-Based Products

Islamic banks offer a wide spectrum of fee-based services using three types of ontracts,*wakalah*, *kafalah*, or *ju'ala*. They are usually auxiliary to the main *murâbaḥah* and *mudârabah* transactions, though they generate various types of fees and commissions. The fee-based services provided by Islamic banks include bank transfers, issuing letters of credit and guarantees, credit cards, and offering collection and safe-custody services, mostly used in trade financing. *Wakalah* results from the bank acting as the agent of a customer in a trade transaction or issuing a letter of credit facility. *Kafalah* is a financial guarantee whereby the bank gives a pledge to a creditor on behalf of the debtor to cover fines or any other personal liability. It is widely used in conjunction with other financing modes or documentary credits.
*Ju'ala* is essentially an *istisna'* contract that is applicable for rendering a specified service as opposed to the manufacturing of a product. Mumtaz H (2015)
Appropriate modes of financing, as recommended by experts on Islamic finance, for particular transactions are given below.

**Modes for Financing Trade, Agriculture and Industry**

Murabaha, instalment sale, leasing and Salam are particularly suitable for trade, while Istisna'a is especially suitable for industry. More specifically, in trade and industry, financing is needed for the purchase of raw materials, inventory (goods in trade) and fixed assets as well as some working capital, for the payment of salaries and other recurrent expenses. Murabaha can be used for financing of all purchases of raw materials and inventory. For procurement of fixed assets, including plant and machinery, buildings, etc., either instalment sale or leasing can be used. Funds for recurrent expenses can be obtained by the advance sale of final products of the company using Salam or Istisna'a.

**Household, Personal Finance, Consumer Banking**

Personal finance for consumer durables can be provided through Murabaha, leasing and ins pecial cases by way of return-free loans out of the current accounts or the banks' own funds (depositors' money in PLS accounts is a trust in the hands of banks and should not be used for charitable and social purposes without their explicit approval).

Wakalah and Murabaha can be used for cash financing through charge and credit cards.

The alternatives for auto finance are Ijarah Muntahia-bi-Tamleek and Murabaha.

Housing finance is possible through Murabaha, Diminishing Musharakah and rent-sharing.

**Treasury Operations – Liquidity and Fund Management**

Liquidity management means ensuring that the bank has sufficient liquid funds available for a smooth running of its operations and to meet short-term financial obligations as and when due. It has to invest surplus funds, match maturity of assets and liabilities, accommodate decreases in deposits/liabilities and increases in assets in an efficient and economic manner. Fund management refers to securing and managing funds for the development of business. Islamic banks may sell and purchase Sharı´ah-compliant money and capital market instruments like stocks and Sukuk. Direct placement or acquisition of funds (in the inter-bank funds market) on the basis of Mudarabah and Musharakah is also possible. The deficit bank agrees to give a share of its profits according to a Mudarabah ratio that can either be negotiated according to the market conditions or recommended by the central bank, for the duration of the contract. In the case of Mudarabah, the following process can be adopted:

1. A Mudarabah relationship will be created.
2. Funds received will be allocated to pools.
3. Weightages will be assigned periodically, based on different tiers/categories.
4. Profit earned will be allocated according to weightages assigned at the beginning of the period.
5. The bank will charge a pre-agreed Mudarib fee as a percentage of the realized profit; the bank can pay additional profit from its own share.
6. The investor will bear a loss unless it arises from misconduct or negligence of the Mudarib.  Ayub (2007)

**Government/Public Sector Financing**
Government and public sector enterprises can obtain finance by way of Mudarabah or Musharakah certificates, which can be issued to purchase equipment or utility-generating assets in order to lease them to public sector corporations. Ijarah and Istisna'a are best suited for infrastructure projects in the public sector. Recently, Ijarah Sukuk has emerged as the most crucial instruments for financing of the public sector. Through syndication arrangements, Islamic banks can supply goods/assets of enormous value to government entities or corporations on a Murabaha basis by setting up joint Murabaha funds. In such cases, ownership of Murabaha funds can also be securitized to offer equity-based investment opportunities to the investors and the banks themselves. Returns on these funds would be distributed among Sukuk/certificate holders on a pro rata basis.

### 3.4.4 Islamic financial Markets Instruments (Money and Capital Markets)

**a) Islamic Capital Market (ICM) Instruments**
As discussed previously, the Islamic capital market instruments under equity and debt markets as the basic components of the ICM.
Islamic financial market instruments can represent the following assets:
• Ownership in a company or a business, e.g. stocks and Musharakah or Mudarabah Sukuk;
• Ownership of durable assets or the usufruct of such assets, e.g. Ijarah Sukuk;
• Ownership of debt arising from Murabaha, Istisna'a or Salam financing;
• A combination of the above categories.

**b) Tradability**
• Islamic money market instruments can either be tradable or non tradable in the secondary market;
• Instruments representing ownership in business, real physical assets and usufructs are negotiable at market prices;
• Instruments representing ownership of debt are not tradable in the secondary market, as sale of debt is not permissible in Islamic law;
• Instruments representing a combination of different categories are subject to rules relating to the dominant category. Khan, 1995
.

**c) Sukuk Structures**
• Musharakah Sukuk
— Co-ownership of assets or business with control and management rights;
— Payments supported by income generated by assets of business;
— Tradable.
• Mudarabah Sukuk
— Ownership of assets or business without control and management rights;
— Payments supported by income generated by assets of business;
— Sradable.

• Ijarah Sukuk
— sale and lease-back structure;
— Could either be based on fixed or floating rate structures;
— Payments supported by lease rentals;
—Ttradable.
• Salam Sukuk
— Ownership of debt resulting from a Salam transaction (i.e. advance payment of funds, future delivery of assets);
— Short-term maturity;
— Nontradable.
• Istisna'a Sukuk
— Ownership of debt arising from an Istisna'a transaction (i.e. advance payment of funds, in full or in instalments for construction of an asset);
— Nontradable. Chapra, (1998)

**d) Islamic Money Market Instruments**

The Islamic money market is an avenue for short-term funds, providing a ready source of funds for deficit units, and as an investment outlet for surplus units. Deficit units could raise funds from the Islamic money market by borrowing from interbank players, through the sale of papers or by borrowing from the Central Bank. However, the instruments used in this market must be shariah-compliant. There are several principal instruments in the Islamic money market like mudarabah, bay al-dayn, bay al-inah, qard hassan, bithaman ajil, musharakah, murabahah and so on.
First is bay bithaman ajil (BBA), an agreement that refers to the sales and purchase transaction for the financing of an asset on a deferred payment basis within a pre-agreed payment period. The sale price will include a profit margin.
Second is bay al-inah, defined as a transaction which involves the sale and buy-back of an asset by the seller. The seller will sell the asset to the buyer on a deferred basis and later buys back the same asset on a cash basis at a price which is lower than the original selling price.
Third is mudarabah, an agreement which is made between two parties to finance a business project. The parties are a rabb al-mal or investor who provides the capital and a mudarib or the entrepreneur who will manage the project. Profits derived from the project or investment will be distributed based on a pre-agreed ratio and any loss will be borne by the investor.
Fourth is murabahah, an agreement that refers to the sale and purchase transaction for the financing of an asset or project whereby the costs and profit margin mark-up are made known and agreed to by all parties. The settlement for the purchase which can be done in cash or in installments will be specified in the agreement.
Fifth is musharakah, a partnership arrangement between two parties or more, to finance a business project whereby all parties contribute capital either in the form of cash or in kind for the purpose. Any profit derived from the project will be distributed based on a pre-agreed profit sharing ratio, but losses will be shared on the basis of equity participation.

Sixth is qard hassan, a contract of loan between two parties on the basis of social welfare or to fulfill a short-term financial need of the borrower. The amount of repayment must be equivalent to the amount borrowed. It is, however, legitimate for the borrower to pay more than the amount borrowed as long as it is stated or agreed at the point of contract. Seventh is bay al-dayn, sale and purchase transaction on a quality debt i.e. the default risk of the debtor is low, and the debt must be created from the business transaction that conforms to Shariah. Finally, hibah, hiwalah, and ibra. By definition, hibah refers to a gift awarded to a person on voluntary basis. Hiwalah refers to a contract that allows the debtor to transfer his debt obligation to a third party. Ibra refers to an act by a person to withdraw his right to collect payment from a person who has the obligation to repay the amount borrowed from him. Sundrarajan et al (2002),

Some of the more popular instruments transacted in Islamic money market include Government Investment Issue (GII), Islamic Treasury Bill (ITB), Islamic Negotiable Instrument (INI) and Negotiable Islamic Debt Certificate (NIDC).

i. **Islamic treasury bills (ITBs)**

ITBs are government securities with initial maturities of less than one year. They are often considered the lowest-risk securities available. Only Islamic banks and principal dealers are allowed to tender for ITBs. However, both conventional and Islamic banking institutions are allowed to trade ITBs in the secondary market. ITBs will be traded based on the principle of bay al-dayn. Bay al-dayn refers to the sale of a debt arising from a transaction in the form of a deferred payment sale. The secondary market trading of ITBs will be in terms of yield.

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ii. **Government investment issues (GIIs)**

This is a non-interest-bearing instruments issued by the government to enable Islamic banks and other institutions to invest their liquid funds according to Islamic principles. The Islamic bank governed by Shariah Law, is not permitted to hold interest-bearing government securities, these instruments are issued by central banks on behalf of Government and certificates are issued, with maturities of one year or more for dividends instead of interest, to be paid on the certificates. The returns are declared by the government on the anniver sary date of the certificates.'

Government Investment Issue was introduced based on the contract of bay al-inah in Malaysia in 2001. This instrument can be traded in secondary markets based on bay al-dayn and is used as a monetary instrument by the Central Bank.

iii. **Islamic negotiable instruments**

The rapid development of Islamic banking has accelerated the need to create an Islamic version of Negotiable Instruments of Deposits (NID). There are two types of NID. The first are Islamic Negotiable Instruments (INI), structured on the concept of bay bithaman ajil for Negotiable Islamic Debt Certificate (NIDC). The second Islamic Negotiable

Instruments (INI) which are structured on the concept of mudarabah for Islamic Negotiable Instruments of Deposits (INID).

iv. **Islamic accepted bill (IAB)**

IAB is a bill of exchange, which is drawn by the bank and accepted by the purchaser, thus creating a debt owing to the bank. The bank, in turn, may sell the IAB in the secondary market at a discount value under the bay al-dayn concept. IAB can be divided into two: IAB-Import or Purchase and IAB-Export of Sales. IAB-Import or purchase is transacted using murabahah Letter of credit which is an import trade finance facility whereby the bank purchases the goods at cost and sells to the importer on a mark-up basis payable at a determinable future date. IAB-Export of Sales is a bill of exchange, which is drawn by the exporter and accepted by the exporter's bank if the exporter's bank buys the debt from the exporter. Hannuddin et al (2017)

## 4.0 Tutor-Marked Assignment

-Identify and explain the various Islamic financial instruments used in Islamic financial institutions and markets and their uses to both investors and financial institutions.

## 5.0 Summary and conclusions

It can be deduced from the discussion that Islamic financial instruments forms the contractual agreement of undertaking a transaction based on the principle of Shari'ah, risk sharing and equity based. These instruments serve as financial assets to investors, means of payment and productive investments to participants with a return.

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## UNIT FOUR: CHALLENGES FACING ISLAMIC FINANCIAL INSTITUTIONS

**1.0 Introduction**

**2.0 Objectives**

**3.0 Main Content**

### 1.0 Introduction

This unit will discuss the various challenges facing the growth and survival of the Islamic finance industry across the globe despite its rapid development.

### 2.0 Objectives

The aim of this unit is to enable the students to comprehend:

- The various factors that negates the active performance of IFIs globally
- The challenging issues faced by IFIs in meeting the global financial standard in transaction.

### 3.0 Main Content

#### 3.1 Challenges facing Islamic Finance Institutions

Globally, Islamic finance has exhibited its potential through the ever-increasing number of Islamic financial institutions (IFIs). The Islamic financial industry is still growing and is finding its niche in many Muslim as well as non-Muslim countries. The growth is swift, but it is accompanied by various issues and challenges that will need to be addressed in order to facilitate
and coordinate the innovation and diversity that it brings. The following issues are found to be the challenges:

#### I. Harmonization and Standardization

The biggest challenge faced by the regulators of Islamic finance is harmonizing and standardizing these interpretations into a consistent and efficient regulatory framework that will ensure unimpeded Islamic financial intermediation among the participants. The process of harmonization and standardization of transactions across and within borders is undoubtedly a daunting one and has to be comprehensive. In some jurisdictions certain transactions are considered *shariah*-compliant,while in others they may not be accepted as so. It is extremely difficult to adjudge as to which is the closest to *shariah*.

#### II. *Shari'ah* Expertise

The lack of *shariah* expertise is one of the challenges that face the regulators of the Islamic financial industry. Due to the infancy of the system, very few institutions have produced the desired skill set for the Islamic financial and banking industry. While there

are plenty of Islamic jurisprudence experts, there is a dearth of Islamic financial experts with a knowledge of the dynamics of conventional finance and its transformation to an Islamic/*shari'ah*-compliant system due to the regulatory obligation of instating *shari'ah* supervision, IFIs employ less experienced *shari'ah* scholars, as only a limited number of professionals are available and they are usually attached to more than one IFI concurrently.

**III. *Shari'ah*-Compliant Securities**

The limited number of *shariah*-compliant securities emanates from the lack of both harmonies and Islamic financial prowess, and poses yet another problem in the development of the industry. Due to the paucity of available instruments in the market, investors are constrained to take their funds elsewhere. The limited choices also affect the liquidity of the securities as there is a limited market for them. The buying and selling of such securities is not as lively as in the conventional securities market.

**IV. The liquidity risk management of Islamic banks**

This is an important challenge and is constrained due to the limited availability of tradable Islamic money market instruments and weak systemic liquidity infrastructure. At the moment, there is no *shari'ah*-compliant short-term Islamic money market (of less than one-week maturity) in local currency or in US dollars, and Islamic repo markets (for funding liquidity) have not yet developed. Islamic money markets with longer maturities sometimes suffer from an unreliable clearing and settlement process. Islamic banks also have a competitive disadvantage compared to conventional banks, as they deposit their overnight money with their domestic central bank at no interest. Errico L et al (2010)

**V. Transparency**

This has been a challenge and needs to be a focus of Islamic regulatory agencies. Development of an efficient infrastructure that supports free markets and transparency and adheres to international standards will increase the credibility of Islamic financial products and services. Transparency is also needed in Shari'ah decisions by Shari'ah scholars when determining which Islamic financial products are deemed Shari'ah compliant. Disclosure is needed in order to increase the credibility of Shari'ah decisions. Outsider Shariah scholars should also be utilized in order to prevent conflicts of interest from insider Shariah scholars when assessing Islamic financial instruments.

## 4.0 Self-Assessment Exercise

- Give and explain the various challenges facing Islamic finance industry.

## 5.0 Summary and Conclusion

We can understand the challenges arising from the operations of IFIs are attributed to regulatory issues and paucity of the Islamic financial instruments as well as human capital management.

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# MODULE 3: REGULATORY FRAMEWORK OF ISLAMIC FINANCIAL SYSTEM

**Content**

**UNIT ONE: Rationale for Regulations of Islamic Finance Institutions**

**UNIT TWO: Role of Regulatory and Supervisory authorities for Islamic Finance**

**UNIT THREE: International Standard-Setting organizations**

## UNIT ONE: Rationale for Regulations of Islamic finance

**Content:**

**1.0 Introduction**

**2.0 Objectives**

**3.0 Main Content**

**3.1 The regulation of Islamic Finance**

**3.2 Reasons for the regulation**

**4.0 Summary and conclusion**

**5.0 Self-study questions**

**6.0 References/Further Readings**

### 1.0 Introduction

In this unit, you will learn about regulating Islamic financial institutions and the reasons behind that.

### 2.0 Objectives:

At the end of this unit, you should be able to:

- Understand the need for regulation in the development of Islamic finance.
- Know the key regulatory framework for Islamic finance institutions

## 3.0 Main Content

### 3.1 Regulations of Islamic Financial Institutions

The financial services industry is the most regulated service industry in modern society. A principal reaon for this ithat maintaining confidence in its institutions and instruments s key to its existence, health and sustainability, and the players in the industry cannot be trusted to provide or maintain that confidence, thus the need for regulators.

Among the features that distinguish Islamic financial system with the conventional financial system are the regulations that govern them as well as governance mechanisms they adopt. Conventional institutions have been established and governed by secular, man-made laws and regulations, Islamic financial institutions while still expected to conform to some existing laws of Man- made laws and regulations as its conventional counterparts, must also adhere to the divine rules and principles in the form of a body of laws as Shari'ah.

As IFIs in its modern form is indeed a recent phenomenon that started only about four decades ago, it is understandable that legal and regulatory practices governing IFIs remain varied across countries. While most countries that operated IFIs had adopted the dual-financial system (Islamic finance operating in parallel to conventional finance), a few others such as Iran and Sudan had adopted a single Islamic financial system. The decision by each country to adopt either a single or dual financial system is pre-dominantly influenced by their respective socio-political histories and realities rather than by economic factors. Hence, the merit or demerit of a single or dual financial system cannot simply be generalized but must be appraised on a case-by-case basis.

In countries like Saudi Arabia and Egypt, no specific Islamic banking laws are enacted to govern the specificities of the IFIs. Thus, they operate under the same laws governing conventional banks. Whereas in countries with a single, banking system such as Sudan and Iran, which is Islamic, they have adopted Islamic accounting standards, established requirements for Shari'ah Supervisory Boards as well as put in place supervisory framework specific for IFIs. However, these laws vary in terms of their scope and some appear to replicate the regulatory and supervisory framework applied for conventional banks onto the IFIs. This is done without fully taking into account, the unique characteristics of Islamic banking. Bshir A (2005)

### 3.2 Reasons for Regulations of Islamic Finance Institutions

The integration and interconnectedness of the Islamic finance system at both national and international levels means that the Islamic finance industry cannot exist in isolation, a fact that makes regulators to by necessity playing a role in the stablishment and development of the Islamic finance industry in various jurisdictions.

Chapra & Khan (2000), in their study identified and suggested four reasons for the need of regulation of IFIs as follows:

### 3.2.1 Systematic Considerations

A key systematic consideration is the risk of "contagion" whereby if one financial institution fails; the sustainability of others is threatened. Regulation I also needed to maintain an efficient payment system and mitigate the risks of disruption of payments. Regulators also often have to manage a delicate balance between promoting economic development (which may require a more aggressive risk-taking environment) and ensuring the stability of the financial system (which may require more conservative approach towards risk taking).

### 3.2.2 Protecting the Interest of Depositors and Investment Account Holders (IAHs) of IFIs

In many jurisdictions, the existing regulations do not cater for the distinct contractual rights and risks profiles between normal depositors and IAHs. As such there is a need to adopt a cross – sectoral approach to Islamic finance regulations whereby the banking regulators' usual emphasis on depositor protection has to be balanced with the securities regulators' approach of investor protection, particularly for IAHs. While current account holders in IFIs are capital-guaranteed and therefore protected like any conventional depositors, IAHs contractually are supposed to bear their own risks. Therefore, since they may not enjoy any capital guarantee, they should have rights for additional investors' protection. Such a protection might be through a more representative governance system and a more transparent disclosure regime. This may also be aligned to the need to safeguard efficient use of public resources and adequate integrity in fiduciary contracts.

It is obvious for IAHs as investors to expect transparency from the IFIs in terms of the features of the contract they enter into and appropriate recourse if the contract is breached. In this respect, regulations promoting the integrity of fiduciary contracts would be consistent with the theory of Islamic finance. IFIs also face competitive pressures to protect their investment base by providing sufficient security assurance and returns the same as, if not better than, those of conventional institutions. Therefore, hey need regulations that can help level the playing field in their favour.

### 3.2.2 Ensuring Compliance with Shari'ah

IFIs are prohibited from recognizing as profits any income derived from transactions that do not comply with Shari'ah tenets. Such tainted income has to be screened and channeled to charity. As the level of interface between common, civil and religious laws vary across jurisdiction, mainly due to socio-political history. In countries where historically, the legal systems were inherited from former colonial powers and Shari'ah rules and principles subscribed by IFIs and Muslims are not aligned to co-exist harmoniously, many legal issues may appear whenever a dispute arises from an Islamic financial contracts. Questions of credibility may be posed to financial regulators in terms of their capacity to ensure Islamic financial intermediation activities comply with Shari'ah or to conventional courts in terms of their competence in resolving Islamic finance disputes. In jurisdictions where the legal system manages to harmoniously accommodate man-made laws with the divine Shari'ah rules and principles, the public would have stronger confidence in the role of financial regulators and the courts. In recent years, the establishment of a Shari'ah supervisory body that can provide assurance in the strategic direction, formulation of policies and conduct of financial transactions of IFIs are in compliance with the Shari'ah rules and principles have become an important aspect for instilling public confidence.

### 3.2.3 Supporting the Integration of IFIs in the International Financial System

Today, Islamic finance has evolved into a viable and competitive component of the international financial system. Following the global financial crisis of 2008-2009, has brought to the forefront wide ranging issues concerning the international financial systems. Amidst this more challenging environment presented by the recent international financial crisis, the global expansion of Islamic finance has continued and its development has remained dynamic. Today, Islamic finance has become one of the fastest growing financial segments in the international financial system. It's phase of development that began in earnest as domestic-centric for Muslim economies, has rapidly transformed in this recent decade to become internationally recognized and accepted as a competitive and robust form of financial intermediation by communities.

The international dimension of Islamic finance has rapidly gained significance as it evolves to become an increasingly important part of the international financial system, and as is becomes poised to contribute towards greater global financial integration. Islamic financial institutions have now ventured beyond their domestic borders and funds raised in Islamic financial markets in different jurisdictions have drawn investors from financial centers across the globe. As market players across continents participate in the expansion of inter-regional investment flows, it has enhanced financial linkages among the major regions. To date, the number of Islamic financial institutions worldwide has increased to more than 300, spanning more than 75 countries both in the Muslim and

non-Muslim countries. The expansion of the inter-linkages among intermediaries and markets across regions would contribute towards a more efficient allocation of financial resources across borders and thus contribute to enhancing global growth prospect. Monsab T (2014)

## 4.0 Summary and Conclusion

In this unit, we have discussed the factors/reasons that determine regulations of Islamic financial institution. Reasons for the regulation of the Islamic financial system have been explained in terms of ensuring Shari'ah compliance, supporting the integration of these institutions with international financial system and investor protection.

## 5.0 Self-study Questions

Explain the key reasons for regulations of IFIs.

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## UNIT TWO: REGULATORY AND SUPERVISORY AUTHORITIES FOR ISLAMIC FINANCE

**Content**

**1.0 Introduction**
**2.0 Objectives**
**3.0 Main Content**
**3.1 Central Bank**
**3.2 Shari'ah Advisory Council**
**3.3 Regulatory Framework of Non interst Financial Institutions in Nigeria**
**4.0 Tutor – Marked Assignment**
**5.0 Summary and Conclusion**

### 1.0 Introduction

This unit introduces the key regulatory authorities of the Islamic financial industry as internal regulators and their legal, supervisory and regulatory powers enforced on them to perform their functions.

### 2.0 Objectives

This unit entails to enlighten the students on:

- The key functions of the regulatory authorities.
- Their supervisory and legal frameworks
- Environmental controls of the economic and financial issues emanating.

### 3.0 Main Content

#### 3.1 Central Bank

Central banking as an economic and finance concept originated from Europe in the 17th century. It involves the foremost financial institution in the economy which is often called the Central bank (CB) and it is regarded as the apex bank. It raises funds for government and serves as the government's banker. The foremost CB to be established is the Bank of England in 1694, which started as corporate entity i.e. as a joint stock company. Subsequently, it acted as the government's banker and in the 1830s and it became the sole issuer of currency notes. Since then, the concept of central banking has gradually evolved and developed , to become what we now generally know today (INCEIF, 2006a & Usman, 2003). Therefore, CB is basically considered as the bank responsible for the monetary and banking structure and operations in any economy. Generally, the objectives of a CB include:

i. Currency issue and managing the nation's international reserves;

ii. Banker and advisor to the Government;

iii. Ensuring monetary stability; and

iv. Providing a sound financial system.

It is also important to state that the CB controls, regulates and supervises all financial institutions for the purpose of monetary and financial stability. Being the main financial institutions regulator, it is empowered to grant and revoke banking licenses. However, the CB is directly responsible for the control, regulation and supervision of all financial institutions, especially the banking sector. In view of this, the CB has three main policy tools and two subsidiary tools. These policy tools are: i. Open Market Operations (OMO); ii. Discoun window and iii. Reserve requirements. The subsidiary tools are Margin requirements and Foreign exchange operations (INCEIF, 2006a). These important role and functions thus establish the direct and positive relationship between the CB and all the financial institutions and by extension Islamic banks (IBs ) in especially Muslim economies where Islamic banking is much rooted.

It is an established fact that in most countries, a central bank, being the authority responsible for policies affects a country's supply of money and credit, would regulate and supervise financial institutions including IFIs with different mandates. These mandates largely determine whether a central bank can play an active or passive role in the development of the Islamic financial services industry of its country.

Chapra (2009, p. 50) made it clear when he submits: "All financial institutions and not just the commercial banks need to be properly regulated and supervised so that they remain healthy and do not become a source of systemic risk". Hence, there is the urgent need by regulatory bodies, especially the central banks (CBs) to ensure the adequate regulation and supervision of not only IBs but also other financial institutions in the economy. In view of this, one of the most important role and functions expected of every CB is the regulation, supervision and control of banks and other financial institutions in the economy. However, it needs to be stressed that under an Islamic system, the role and operations of the CBs will be multi-dimensional and complex than the traditional banking system (INCEIF, 2006b).

In recent years, it has been well-recognized that the three main roles of a central bank are to ensure:

1 Price stability or stability in the value of money (this is also understood as maintaining a sustained low rate of inflation).

2 A stable real economy: This is often interpreted as high employment and high and sustainable economic growth as the monetary policy adopted by the central bank is expected to smooth the business cycle and offset shocks to the economy.

3. Financial stability: this encompasses an efficient and smoothly running payment system and the prevention of financial crises.

However, we shall learn about the different mandates given to authorities that regulate and supervise IFIs, and their experience in developing the Islamic financial services industry in their respective countries. The following section provides an analysis of the experience of the regulatory and supervisory authorities in Malaysia. These authorities have successfully developed the country as a leading international Islamic financial hub.

### 3.1.1 Malaysia's Experience

In Malaysia, the role of the central bank is entrusted to Bank Negara Malaysia (BNM) which was established on 26 January 1999 under the Central Bank of Malaysia Act 1958 (CBA 1958) to act as Malaysian banking financial institutions supervisor. CBA 1958 had been repealed by the Central Bank of Malaysia Act 2009 (CBA 2009) which became effective on 25 November 2009. The roles and responsibilities of BNM have evolved and expanded due to its dual financial system. Malaysia has now developed a comprehensive Islamic financial system that includes the banking and takaful industry, other financial institutions and the Islamic money and capital markets. The supporting financial infrastructure includes a robust regulatory and supervisory framework reinforced by the legal and Shari'ah framework, the payment and settlement systems, and the development of the pool of expertise and talent to support the industry. Under the Financial Sector Master plan (2001-2010), the development of the Malaysian Islamic financial system has been given specific focus in the following:

- Islamic banking system
- Islamic inter-bank market
- Islamic capital market
- Islamic Debt market
- Islamic equity market
- Takaful Industry

### 3.1.2 Legal, Regulatory and Supervisory Infrastructure

To enable BNM to meet its objectives, it is vested with comprehensive legal powers under the CBA 2009. Among the important provisions that were introduced under the CBA 2009 Act is:

I. The acknowledgement that Malaysia will have two financial systems i.e Islamic financial system and the conventional financial system.
II. The enhanced mandate of the National Shari'ah Advisory Council (NSAC). The purpose is to promote consistency in Islamic financial legislation and to raise the status of the NSAC as the highest Shari'ah authority in the country when it comes to Islamic finance. In line with such objectives, the CBA 2009 stipulates that the courts and arbitrators shall refer to the NSAC on matters pertaining to Shari'ah, and that SAC decisions shall be binding on them.
III. The commitment of BNM to promote and position Malaysia as an international Islamic centre. Abdul Ghafar (2010)

### 3.2 Shari'ah Advisory Council

According to the guidelines (GPS1) of Islamic banks, the latter is required to set up a Shari'ah Advisory Council (SAC) to supervise its operations to ensure that those operations comply with the rules of Shari'ah. The SAC also takes the views of the Shari'ah committees of relevant authorities such as bank Negara Malaysia and the securities Commission on issues relating to the industry.

Furthermore, for an Islamic bank to be licensed under the IBA act, the bank must satisfy all the conditions under section 3(5) of the IBF ACT, namely, that the banking business which the bank desires to carry on will not involve any element which is not approved by the principle of Shari'ah and that there is provision for the establishment of shari'ah advisory council in the banks articles of association. The guideline provides that a Shari'ah advisory council whose members would be made up of muslim religious scholars shall be established to advise the bank on the operation of its banking business. The council shall have a minimum of three and maximum of seven members, whose appointments shall be acceptable to the relevant government minister for a term not exceeding two years after which each member is eligible for reappointment.

The duties and responsibilities of SAC are to review, appraise and advise the directors on the operations of the banks business in order to ensure that they do not involve elements, which are not approved by Islam. The roles of SAC in monitoring the Banks activities are as follows;

a) Review the products and services to ensure conformity with Shari'ah requirements;

b) Deliberate on Shari'ah issues pertaining to the day-to-day operations of the bank on whether they are Shari'ah complaint;

c) And provide training and education on muamalat or Islamic transactions based on Shari'ah principles.

d) The Shari'ah Advisory council has the authority to scrutinize and approved documents used by Islamic banks.

Nevertheless, although all transactions including products and services offered have to be first approved by the council in order to ensure that they do not involve non-Islamic elements, it is open to any interested party to challenge such transactions as being contrary to Islamic law as there is nothing in the IBA act which states that, once an operation has been approved by the banks Shari'ah Advisory Council, it may not be called into question or reviewed by any court of justice.

In fact, the IBA act itself seems to imply that the approval of an Islamic banks Shari'ah Advisory Council on any aspect of its operations is not final and conclusive since, under section 11 of IBA act, the minister of Finance may, on the recommendation of central Bank, revoke the license issued to the bank if it is pursuing aims or carrying on operations involving non-Islamic elements.

### 3.2.1 The major Functions of a Shari´ah Supervisory Board In the Light of the AAOIFI's Sharı´ah Standard

The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) has prepared a standard for a Sharı´ah supervisory board, its composition and related aspects like rulings, report, etc. According to this standard, a Sharı´ah board should be an independent body of specialized jurists in Islamic commercial jurisprudence. It may also include other experts in areas of Islamic financial institutions with knowledge of Islamic jurisprudence relating to commercial transactions.

The Sharı´ah board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that it is in compliance with Islamic Sharı´ah rules and principles. The Fatwahs and rulings of the Sharı´ah supervisory board are binding on the Islamic financial institution.

According to the AAOIFI Standard, a Sharı´ah board should consist of at least three Sharı´ah scholar members. It may seek the services of consultants having expertise in business, economics, law, accounting and/or others. It should not include directors or significant shareholders of the Islamic financial institution. (AAOIFI, 2004–5b, Governance Standard No. 1, Sharı´ah Supervisory Board, para. 13.)

The following is the illustrative wording of any Sharı´ah board's report on operations of Islamic financial institutions:
"We have reviewed the principles and the contracts relating to the transactions and applications introduced by the Islamic Financial Institution (IFI) during the period ended _ _ _ We have also conducted our review to form an opinion as to whether the institution has complied with Sharı´ah rules and principles and also with the specific Fatwahs, rulings and guidelines issued by us.
We conducted our review, which included examining, on a test basis of each type of transaction, the relevant documentation and procedures adopted by the Islamic Financial Institution. We planned and performed our review so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the institution has not violated Islamic Sharı´ah rules and principles." (AAOIFI, 2004–5b, Governance Standard No. 1, Sharı´ah Supervisory Board, para. 16.)

The Sharı´ah board should particularly focus on the Sharı´ah compliance of financial structures, including products, documentation and the process of transactions. Where appropriate, the report of the board should include a clear statement that the financial statements have been examined for the appropriateness of the Sharı´ah basis of allocation of profit between the equity holders and the depositors.
The Sharı´ah board's report should also include a clear statement that all earnings that have been realized from sources or by means prohibited by Islamic Sharı´ah rules and principles have been disposed of to charitable causes. In the case of violation of any Sharı´ah rules or rulings of the Sharı´ah board, the board should indicate the violations in its report.
The central Sharı´ah boards may also approve the fit and proper criteria for appointment of Sharı´ah advisors in Islamic banking institutions.

The AAOIFI has also issued standards on Sharı´ah review by the Sharı´ah boards (Governance Standard No. 2) and internal Sharı´ah review (Governance Standard No. 3) by an independent internal audit department of the respective banks. Sharı´ah review is to be carried out in the following stages:

a. Planning review procedures.
b. Executing the review procedures and preparation of working papers.
c. Documenting the conclusion and report.

Internal Sharı´ah review should be conducted to examine and evaluate the extent of compliance of the Sharı´ah rules in the light of the guidelines provided by the Sharı´ah supervisory board. Ayub (2007)

### 3.3 Regulatory Framework of Non interest Financial Institutions in Nigeria

Nigeria`s Islamic finance industry largely depends on constitutional provision and guidelines from relevant regulators. The Central Bank of Nigeria, National Insurance Commission (NAICOM) Securities and Exchange Commission (SEC), Nigeria Deposit Insurance Corporation (NDIC) and Pension Commission (PenCom) have been issuing related guidelines on the modalities and operations of Non-Interest Financial Institutions in the country. The IFI has three segments namely; Islamic banking institutions, Islamic funds and Islamic insurance entities. The three are regulated and supervised by different regulators. The central bank of Nigeria (CBN) regulates and supervises banking institutions; the Securities and Exchange Commission regulate capital market institutions and instruments; and the National Insurance Commission (NAICOM) regulates insurance.

The central bank is the body mandated by the laws of Nigeria to license, regulate and supervise banks, therefore Islamic banking institutions fall under its regulatory purview. Its approach to the introduction of Islamic banking is pvoted around two points:

-Implementation of a national policy dating back to 1991 when the bank and other Financial Institutions Decree was enacted which was amended and passed as an act of the National Assembly recognizes profit and loss sharin banks and exempts them from dealing with interest. Implementation of theFinancal System Strategy 2020, which has the vision of turning Nigeria into a major international financial Centre in Africa transform it into one of the largest economies of the world by the year 2020. Part of the initiative is financial inclusion through creation of non-interest institutions and instruments to attract and integrate the huge unbanked and under banked segments of the society into the organized financial sector.-Mustafa et al (2011)

#### 3.3.1 Central Bank of Nigeria (CBN) Act 2007

All banks without special reference to Islamic banks are operating under the regulatory structure of this Act. CBN which coordinates each financial institution across the nation constitutes its governing body under the CBN Act 2007 (Bambale, 2007).

One of the strategies adopted by CBN was that a framework was introduced for non-interest banks to operate at the monetary market. This was achieved through the Islamic window model, wherein every conventional bank is permitted to offer Shariah certified products and services. This is because conventional banks dominate the country. Also, such bank offering those Islamic products will not concurrently promote any conventional product contrary to Islamic principles under the same platform (Section 2 (a), Central Bank Act, 2007).

Another attempt proposed by the drafters of the Act towards the expansion of Islamic banking was the formation of a Shariah Advisory Committee. The primary duty of this advisory-committee which is otherwise known as the CBN Shariah Council is to counsel the CBN regulators about Islamic law of transaction matters (Section 2 (c) Central Bank Act, 2007).

Moreover, one of the Guidelines outlining Shariah Governance for Non-Interest Financial Institutions apparently stipulates that duties, qualification and appointment procedure of Shariah board shall fall within the powers of the Governor to make regulations and decisions (CBN, 2011).

### 3.3.2 Guidelines on Institutions Offering Non-Interest Financial Services in Nigeria

To complement the goal of institutionalizing non-interest banking services across the nation, several guidelines were issued with the aim of accelerating the banking operations. Purposefully, these Guidelines were fundamentally enacted for the sake of non-interest financial institutions in Nigeria. Nonetheless, these efforts are yet to drive the system up to the progressive state.

The Guidelines clearly describe the kind of banks that will be given operational-permit in Nigeria without excluding Islamic banks (Section 4 (2), Regulation on the Scope of Banking Activities and Ancillary Matters, 2010). Stakeholders' view, opinions and suggestions are the predominant reasons behind the introduction of the new guidelines. Some important elements are inserted in the new Guideline. For instance, the definition of 'non-interest banks' now includes both forms of non interest banking stated in BOFIA. It is important to add that discrimination is strictly forbidden among stakeholders.

During the amendment process, the identity of Islamic-law experts popularly known as Sharia Council was also changed to Advisory Council of Experts (ACE) whose primary assignment is to advise CBN on compatible and marketable financial products available at the financial market.

These Guidelines also prescribe that any contract containing the ingredients of interest, uncertainty, gambling, speculation, and unjust enrichment and exploitation practices shall be rendered invalid.

Besides, the goal of these Guidelines is to set an operational minimum standard for non-interest banking in Nigeria. Approval procedures, requirements and application fees for non-interest financial institutions are provided in these Guidelines. More so, in order to ease the banking services, templates for operating and managing the system were also outlined.

Seven Islamic financial instruments including Murabaha, Mudarabah, Musharakah, Ijarah, Salam and Parallel Salam, Istisna and Sukuk were listed accordingly in these Guidelines. However, their respective frameworks were not comprehensively detailed therein. Apart from that, an Islamic window service of conventional banks was also included in the regulations wherein cross-selling services were permitted at conventional banks. Another protective section of non-interest banking practice in the Guidelines was that Service Level Agreements (SLA) of shared services between Conventional and

Islamic banks was incorporated. More so, separation of records was considered under the Islamic window agenda (Draft Framework for the Regulation and Supervision of Non-Interest Banks in Nigeria, 2009). Similarly, formulation of Shariah Advisory Committee (SAC) was also allowed and commissioned with the duty of reviewing and evaluating the compliance degree of each product towards Shariah standard (Financial Policy & Regulation Department, Central Bank of Nigeria, Abuja, 2010).

For the sake of guaranteeing adequate liquidity, non-interest banks are desired to set up wide-range policies that will be used to finance their activities. Moreover, regulators were only expected and not yet confirmed to have formulated a risk management system which entails Displaced Commercial Risk (DCR), Fiduciary Risk, Transparency Risk, Sharia Risk, Reputational Risk, Mark-up Risk etc.

Another important feature of the Guidelines is that AAOIFI standard shall often be referred to in case of lacunas (Clause 12.2, Guidelines for the Regulation and Supervision of Institutions Offering Non- Interest Financial Services in Nigeria). In addition to that, special reference was also given to Islamic microfinance banks to the extent that specific Guideline was constructed to that effect. The noninterest microfinance banks whose customers are those earning low-income and people below the poverty line were strictly guided by the Advisory Committee of Experts (ACE) and CBN management.
Besides, commercial transactions such as acceptance of public sector (government) deposits, foreign exchange dealings, international commercial papers, international cooperate finance, international electronic funds transfer, clearinghouse activities, leasing and renting transactions, and as well as dealings in the land were completely considered illegal under non-interest microfinance bank (NIMFB) concept (Clause 2.2, Circular on the Guidelines for the Regulation and Supervision of Noninterest (Islamic) Microfinance Banks in Nigeria, 2017). However, it is practically impossible to ban all the above elements and at the same time assume positive development in the field of Islamic banking.

Significantly, one of the Guidelines provides that sources of NIMFB fund must not exceed the likes of shareholders' fund, customer's deposit or savings, commissions, grants/donations arising from individuals, organizations or any governmental sectors. In the same way, NIMFB shall on monthly basis return documents including Mudarabah deposits, statement of profit and loss, statement of assets and liabilities, profits rate structure, non-performing financing and investment to CBN and NDIC in a period less than 14 days after each month ends. More so, NIMFB will be denied from funding fixed assets, equity investment and branch expansion except for the losses resulting from shareholders' fund.

The introduction of non-interest financial services in Nigeria is not limited to banking services alone. In the insurance sub-sector some companies are offering an alternative insurance product based on Islamic principles, regulated by NAICOM which is called Takaful. Three takaful operators such as African Alliance Insurance Plc started as early as 2003, followed by Cornerstone Insurance Plc, which has a division called Halal

Takaful Nigeria, and the third is Niger Insurance Plc. In the Capital Market sub-sector, the Securities and Exchange Commission (SEC) has issued guidelines on Islamic Fund Management and has earlier registered Lotus Capital as a capital market operator offering fund management under principles of Islamic commercial jurisprudence and ARM Ethical fund as Shari'ah compliant fund management window. SEC has alo released guidelines on the issuance of sukuk for financing government capital projects and corporate institutions.

The NDIC (National Deposi Insurance Commission) that insures bank deposits has come up with guidelnes on non interest (Islamic) deposit insrance scheme to put Islamic banks on a level playing ground with the conventional banks. Mustafa et al (2011)

### 3.3.3 Shari´ah Compliance and Internal Sharı´ah Controls

Ensuring Sharı´ah compliance is the most important job in Islamic banking. Any failure in this regard may cause systemic risk for Islamic banking and income loss for any bank. Audit should be conducted with regular intervals to ensure Sharı´ah compliance. Internal auditors have to identify gaps in the process of financing and the operations department has to refine and amend the products and the procedures. Sharı´ah compliance guidelines should be issued in specific formats with each product programme so that the Sharı´ah audit may be carried out systematically. The product developers and implementers should adopt the policy of learning and improving from mistakes. Another purpose of the audit should be the education of staff members.

Sharı´ah boards of the banks have to play a crucial role in this regard. They should be in a position to offer recommendations as to how to amend the proposed structure of any product in order to make it feasible and Sharı´ah-compatible. They should finalize the model documents and agreements for the modes of financing and try to ensure that banks follow them in all their transactions, in letter and spirit. Whenever a situation arises where there are difficulties in applying any of the formats, the management should bring the problem to the notice of its Sharı´ah board to resolve the related issues.

The personnel of Islamic banks have often been trained in conventional banking and are not familiar with Islamic banking. As Islamic banking is still in a process of evolution, even the senior management may not be experienced or up to date in the latest applications of the Sharı´ah principles. Quite unintentionally, they may fail to carry out their Sharı´ah board's resolutions. For this reason, the board may like to inspect the bank's transactions in detail and give advice as to where they could be improved for compatibility with the Islamic principles. This would not only ensure that the bank is operating in accordance with Islamic law, but would also give the Sharı´ah board itself an opportunity of gaining a deeper insight into the practical problems that arise. In addition,

both the staff and the management would be given an opportunity to enhance their understanding and competence.

Similarly, a large part of Islamic banks' assets may comprise investments in equities/capital markets. Sharı´ah boards must ensure the compliance of criteria for Islamic banks' investments in shares, equities, Sukuk and other avenues of business. This aspect of Sharı´ah control should include prohibition of investment in companies with unacceptable business lines, which produce prohibited products and provide prohibited services like:

• Alcoholic beverages and tobacco products;
• Grocery stores dealing in Haram goods;
• Restaurants, casinos and hotels with bars for prohibited activities;
• Amusement and recreational services likely to involve indecent activities;
• Financial institutions which deal with interest;
• Companies of which the interest income ratio is more than (5) %;
— The debt ratio (leverage) is more than (10–33) %;
— Total illiquid assets are less than 10–33% of its total assets.

If investment is made in the equity of such companies, Haram or interest-related income will have to be given to charity and the Sharı´ah boards must ensure its credit to the Charity Account. Chapra (2009)

## 4.0 Tutor- Marked Assignment

Why do regulators insist that banks should have a Shari'ah Advisory Council?

Give account of the nature of regulatory framework of the Islamic financial institutions operated in your country.

## 5.0 Summary and Conclusion

Major regulatory authorities that regulate the Islamic financial institutions providing internal controls of the activities and contracts compliance with Shari'ah were discussed. Significant functions to be performed by these regulators have been pointed out as outlined by the standard setting body (AAOIFI). Effective supervision of these institutions is required to keep to the standard practically.

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## UNIT THREE: INTERNATIONAL STANDARD-SETTING ORGANIZATIONS

**Content**

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**4.0 Tutor-Marked Assignment**
**5.0 Summary and Conclusion**
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### 1.0 Introduction

This unit will introduce three international standard setting bodies and their functions in regulating Islamic financial institutions i.e., IFSB, AAOIFI and IIFM and IDB as a supporting institution.

### 2.0 Objectives

At the end of this unit, we will be able to know:

- The significance of the international standard setting organizations
- The roles they play in shaping the activities of the institutions

### 3.0 Main Content

Internationally accepted standards and best practices form major reference points for any regulatory framework established by regulatory and supervisory authorities. By design, international standard- setting bodies formulates broad supervisory standards and guidelines and recommends statement of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements-statutory or otherwise- which are best suited to their own national systems. This way the international standard- setting bodies encourage convergence towards common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.

An extensive due process is adopted by international standards-setting bodies in order to develop reasonably sound documents to be adopted by individual regulatory and

supervisory authorities, and to seek broad industry endorsement for their initiatives. This includes establishing well-represented working groups and conducting public consultations before any document is finalized as the international standard.

Various international organizations have been established to set standards that would strengthen and eventually harmonized prudential regulations as they apply to IFIs. In the context of the conception of an adequate regulatory environment, several institutions were created. These include the Islamic Financial Services Board (IFSB), Accounting and Auditing organization for Islamic Financial Institutions (AAOIFI) and International Islamic Financial Market (IIFM).

### 3.1 Islamic Financial Services Board (IFSB)

It is designed to ensure the soundness and stability of the Islamic financial services industry, broadly defined to include banks, capital markets and insurance. It was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry by introducing new, or adapting existing international standards consistent with Shari'ah principles, and recommending them for adoption. As of April 2010, the IFSB has 191 members including 50 regulatory and supervisory authorities, six multilateral inter-governmental organizations including the International Monetary Fund, World Bank, Bank for International Settlements, Islamic Development Bank(TDB), Asian Development Bank and 135 market players and professional firms from 40 countries. (ISRA, 2011)

#### 3.2.1 Roles of IFSB in Islamic Finance

a) The standard-setting work of the IFSB takes into account the need to cater for the specificities of the Islamic financial services industry, while complementing existing internationally accepted standards.
b) Compliance with a common set of internationally recognized prudential standards would help harmonize the regulatory and supervisory framework for the Islamic financial services industry, which may vary greatly across jurisdictions according to national circumstances and practices due to differing interpretations and the way policies are structured.
c) Global acceptance of, and compliance with uniform prudential standards and best practices may help create a level playing field for IFIs among themselves in many regulatory and supervisory aspects before eventually ensuring parity vis-à-vis their conventional counterparts.

## 3.3 Accounting and Auditing Organization of Islamic Financial Organization (AAOIFI)

The unique rules, restrictions and requirements regarding business and investing in Islamic finance must adhere to the principles of Shari'ah in order to be considered acceptable. AAOIFI is an Islamic International autonomous non- profit organization that prepares an accounting, auditing, governance, ethics and Shari'ah standards for IFIs, participants and overall industry.

As an independent international organization, AAOIFI was registered on 27th march, 1991 in Bahrain and supported by institutional members (200 members from 45 countries, so far) including central banks, IFIs and other participants from the international Islamic banking and finance industry worldwide. The founding signatories were the IDB (Saudi Arabia), Al Barakah Banking Group(Bahrain), Dar AlMal Al Islami(Switzerland); Al Rajhi Banking and investment Corporation (Saudi Arabia), KFH (Kuwait) and Bukhari Capital (Malaysia) who were signatories to the agreement establishing the organization in 1989.

The AAOIFI sets compliance standards for institutions that wish to gain access to the Islamic finance market and ensures that participant conform to the regulations set out in Islamic finance.

### 3.3.1 Objectives of AAOIFI

The objectives of the AAOIFI are as follows:

a) To develop accounting, auditing and governance thoughts relevant to the activities of IFIs, with consideration of international standards and practices which comply with Shari'ah
b) To disseminate accounting, auditing and governance thoughts relevant to the activities of IFIs and its application through training ,seminars, publications of periodical newsletters, carrying out and commissioning of research and other means
c) To prepare, promulgate and interpret accounting and auditing standards for IFIs.
d) To review and amend accounting and auditing standards for IFIs.

AAOIFI carries out the objectives highlighted above for two purposes. The first is to enhance the confidence of users in the financial statements of IFIs in the information produced about these institutions. Secondly, it aims to encourage these users to invest or deposit their funds in IFIs and to use their services.

In its efforts to enhance the industry's human resource base and governance structures, AAOIFI now offers professional qualification programs.

### 3.4 International Islamic Financial Market (IIFM)

IIFM was established in 2001 with the collective efforts of the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and IDB as an infrastructure institution. Its mandate is to take part in the establishment, development, self-regulation and promotion of the Islamic capital and money. IIFM's primary focus lies in the advancement and standardization of Islamic financial instrument structures, contracts, product development and infrastructure, and the issuance of guidelines and recommendations for the enhancement of Islamic capital market and money market globally. In addition, development of the global primary and secondary Islamic capital, short –term financial market and the creation of a market for Islamic financial instruments is a key area of the IIFM.

The IIFM's building initiatives include:

- Framework for Islamic hedging which could lead to product development.
- Master Agreement for Islamic treasury murabahah contracts.
- Framework for sukuk and other Islamic instruments, secondary market trading documentation and products.
- Primary and secondary market guidelines, best practices, recommendation and standard documentation.
- Infrastructure improvement including systems and procedures.

### 3.5 Islamic International Rating Agency (IIRA)

The the Islamic International Rating Agency (IIRA) in Bahrain started operations in July 2005. It rates creditworthiness, sharia compliance and corporate governance of financial institutions, and also insurers' financial strength. It has to compete with the large international rating agencies (Haladjian 2006).

### 3.6 Islamic Development Bank (IDB)

Consequent upon the Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul-Qa'da 1393AH (December 1973), the Islamic Development Bank came into existence. The inaugural meeting of the Board of Governors was held in Rajab 1395AH (July 1975) while the bank was formally opened on 15 Shawwal 1395AH (20 October 1975). The aim of the bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah. The Bank with its headquarters in Jeddah has up to 52 countries as its members with the prerequisite of being a member of the

Organization of the Islamic Conference and be ready to accept the terms and conditions as may be decided upon by the Board of Governors. Ibrahim R. A & Kabir M. H (2013)

The following are the functions of the Bank:
- Provision of financial and other forms of economic and social assistance to member countries;
- Participation in equity capital and grants loans for productive projects and enterprises;
- Establishment and operation of special funds for specific purposes;
- Assisting Muslim communities in non-member countries;
- Accepting deposits and raising funds in any other manner;
- Assisting in the promotion of foreign trade, especially in capital goods among member countries;
- Provision of technical assistance to member countries;
- Undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the Shari'ah;
- Provision of training facilities for personnel engaged in development activities.

For effective accomplishment of some of the above functions, especially those related to training, the Board of Executive Directors of IDB inaugurated the Islamic Research and Training Institute (IRTI) in 1401AH (1981CE). In 1403AH (1983CE), the Institute became operational with the aim of undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to Shari'ah, and to extend training facilities to personnel engaged in economic development activities in the Bank's member countries. This Institute has organized series of international workshops, conferences and seminars both at local and international levels. Its publications have become household materials for scholars, economists and practitioners.

## 4.0 Tutor-Marked Assignment

What are the regulatory issues and challenges presently confronted by regulatory authorities of the IFIs in Nigeria? Suggest possible solutions to some of these challenges.

## 5.0 Summary and Conclusion

Islamic financial institutions while expected to conform to man-made laws and regulations as conventional counterparts, must also adhere to the divine rules and principles (Shari'ah). The legal and regulatory practices governing IFIs remain varied across countries, depending on their respective socio-political histories and realities. Most countries that operate IFIs have adopted the dual financial system, and a few others have adopted a single, full-fledged Islamic financial system. In regulating the Islamic finance

industry, the unique characteristics and risks entailed in Islamic banking and its products and services need to be carefully examined and considered. In view of the existence of Shari'ah non -compliant activities investors and fund managers in Islamic capital market cannot freely buy and sell shares without undertaking Shari'ah-screening process from time to time in order to ensure that their investment portfolios comply with Shari'ah. Such screening process involves qualitative and quantitative parameters such as source of income, business activities and financial structures. International standard- setting bodies like IFSB, AAOIFI among others formulate broad supervisory standards and guidelines and recommend statements of best practices in the expectation that individual authorities will take steps to implement them through detailed arrangements which are best suited to their own national systems.

## 6.0 References and Suggestion for Further Readings

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