Chapter One: Financial System in Islam

Dr. Md. Arif Billah[1]

Definition of Financial System

The system to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption.

Financial system consists of a variety of institutions, markets and instruments related in a systematic manner and provide the principal means by which savings are transformed into investments.

Functions of Financial System

The main functions of financial system are as follows:

1. Mobilization of Savings
2. Allocation of Funds
3. Development of Trade
4. Settlement of Commercial Transactions
5. Liquidity
6. Risk Protection
7. Overall Economic Development

Mobilization of Savings

An important function of a financial system is to mobilize savings and channelize them into productive activities. A financial system helps in obtaining funds from the savers or surplus units such as household individuals, business firms, public sector units, central government, and state governments.

Mobilization of savings takes place when savers move into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, bills, bonds, equity shares, etc.

Allocation of Funds

Another important function of a financial system is to arrange smooth, efficient, and socially equitable allocation of credit. Money-lenders and indigenous bankers have been providing finance to their borrowers since long. But their finance suffers from several defects.

[1]Associate Professor of Economics under the Faculty of Shariah at IIUC & Executive member of Research Panel at Islamic Economics Research Bureau (IERB) of Bangladesh & President of Poverty Reduction Economic Movement (PREM)

With modern financial development, new financial institutions, assets and markets have come to be organized, which are playing an increasingly important role in the provision of credit.

Development of Trade

The financial system helps in the promotion of both domestic and foreign trade. The financial institutions finance traders and the financial market helps in discounting financial instruments such as bills. Foreign trade is promoted due to per-shipment and post-shipment finance by commercial banks.

The best part of the financial system is that the sellers or the buyers do not meet each other and the documents are negotiated through the bank. In this manner, the financial system not only helps the traders but also various financial institutions.

Settlement of Commercial Transactions

The financial system facilitates settlement of commercial transactions & financial claims arising out of sale & purchase of goods & services. For this money is used as an instrument which is legally recognized. Therefore values of all transactions including sale & purchase of goods and services are expressed in terms of money only.

Over a period of time, the financial system has evolved other instruments like cheques, demand drafts, credit card etc. for settlement of economic transactions. These instruments are recognized by law as a substitute for money.

Liquidity

In a financial system, liquidity means the ability to convert into cash. The financial market provides investors the opportunity to liquidate their investments, which are in instruments such as shares, debentures and bonds. The price of these instruments is determined daily according to the operations of the market force of demand and supply.

Risk Protection

Financial markets provide protection against life, health- and income-related risks. These risks can be covered through the sale of life insurance, health insurance and property insurance and various derivative instruments.

Overall Economic Development

India is a mixed economy. The Government intervenes in the financial system to influence macro-economic variables like interest rate or inflation. Thus, credits can be made available to corporate at a cheaper rate. This leads to economic development of the nation.

Structure of Financial System

Financial structure refers to shape, components and their order in the financial system. The Indian financial system comprises financial institutions, financial markets, financial instruments and financial services that are continuously monitored by various regulatory authorities,

The basic structure of Bangladesh Financial System is divided into four components which are

1. **Financial Institutions**
2. **Financial Instruments**
3. **Financial Markets**

Financial Institutions

Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return.

Financial institutions act as financial intermediaries because they act as middlemen between savers and borrowers. On the basis of the nature of activities, financial institutions may be classified as:

1. Banking Institutions
2. Non-banking Institutions

Banking Institutions

These institutions mobilize the savings of people. They provide a mechanism for the smooth exchange of goods and services .There are three basic categories of banking institutions are

1. Commercial Banks
2. Central bank

Commercial Banks

Commercial bank is an institution that accepts deposit, makes loans and offer related services. These institutions run to make profit.

Non-banking Institutions

1. Insurance Company
2. DSE & CSE

Financial Instruments

Financial instruments are the financial assets. They may be viewed as financial assets and financial liabilities. . Financial assets represent claims for the payment of a sum of money sometime in the future (repayment of principal) and/or a periodic payment in the form of interest or dividend. Financial liabilities are the counterparts of financial assets.

A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Financial assets and liabilities arise from the basic process of financing. Some of the financial instruments are tradable/ transferable.

Others are non tradable/non-transferable. Financial assets like deposits with banks, companies and post offices, insurance policies, NSCs, provident funds and pension funds are not tradable. Securities (included in financial assets) like equity shares and debentures, or government securities and bonds are tradable. Hence they are transferable.

1. Primary or Direct Instruments
2. Secondary or Indirect Instruments

Primary or Direct Instruments

Primary instruments or direct securities are issued directly by borrowers to lenders. Equity shares, preference shares and debentures are primary securities. Equity shares are ownership securities and risk capital.

The owners of such securities are residual claimants on income and assets and participate in the management of the company. The holders of such securities have preference rights over equity shareholders with regard to both a fixed dividend and return of capital.

Secondary or Indirect Instruments

Indirect securities are not directly issued by borrowers to lenders. These securities are issued via a financial intermediary to an ultimate lender. Indirect securities include mutual fund units, security receipts, securitized debt instruments.

1. Mutual Funds
2. Secondary shares
3. Long term bond
4. Time deposits

Mutual Funds

Mutual funds are simply a means of combining or pooling the funds of a large group of investors. The buy and sell decisions for the resulting pool are then made by a fund manager, who is compensated for the service provided.

Since mutual funds provide indirect access to financial markets for individual investors, they are a form of financial intermediary. Mutual funds issue units to investors, which represent an equitable right in the assets of the mutual fund.

Security Receipts

Security Receipts are bonds issued by Asset Reconstruction Companies to banks when they buy bad loans from them. Normally, when these companies buy bad assets from banks, they do not pay cash up front. The bonds (SR) are issued up to a maximum period of seven years.

Securitized Debt Instruments

Securitization is a financial process that involves issuing securities that are backed by a number of assets, most commonly debt. The assets are transformed into securities, and the process is called securitization. As of 2010, the most common form of securitized debt is mortgage backed securities, but attempts are being made to securitize other debts, such as credit cards and student loans.

Financial Markets

Financial markets are another part or component of financial system. Efficient financial markets are essential for speedy economic development. The vibrant financial market enhances the efficiency of capital formation. It facilitates the flow of savings into investment.

Financial markets are the backbone of the economy. This is because they provide monetary support for the growth of the economy. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services.

These are the markets in which money as well as monetary claims is traded in. A financial market is a broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives.

The financial market has two main components, namely are:

- **Money Market**
- **Capital Market**

Money Market

This is a market for borrowing and lending of short-term funds. It deals in funds and financial instruments that have a maturity period of one day to one year. It is a mechanism through which short-term funds are loaned or borrowed and through which a large part of the financial transactions of a particular country or of the world is carried out.

This market is dominated mostly by government , banks, and financial institutions. The most important feature of the money market instrument is its liquidity. The following are instruments that are traded in the money market:

- **Call and Notice Money Market** is short term finance repayable on demand, with a maturity period of one day to fifteen days, used for inter-bank transactions. Call money is a method by which banks borrow from each other to be able to maintain the credit is high.

- **Treasury Bill** is a promissory note issued by the RBI to meet the short-term requirement of funds. Treasury bills are highly liquid instruments that mean, at any time the holder of treasury bills can transfer of or get it discounted from RBI. These bills are normally issued at a price less than their face value and redeemed at face value.

- **Certificate of Deposits (CDs)** are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions. They can be issued to individuals, corporations, and companies during periods of tight liquidity when the deposit growth of banks is slow but the demand for credit is high. They help to mobilise a large amount of money for short periods.

- The scheme pertaining to CDs was introduced in 1989 by the RBI, to mainly enable commercial banks to raise funds from the market. At present, the maturity period of CDs ranges from 3 months to 1 year. They are issued in multiples of INR 25 lakhs subject to a minimum of INR 1 crore.

- **Commercial Papers (CPs)** Commercial Papers are unsecured money market instruments issued in the form of promissory notes or in demat form. These were introduced in January 1990. Commercial Papers can be issued by a listed company that has a working capital of not less than INR 5 crores.

Capital Market

Capital market may be defined as a market dealing in medium and long-term funds. It is an institutional arrangement for borrowing medium and long-term funds and which provides facilities for marketing and trading of securities .

So it constitutes all long-term borrowings from banks and financial institutions, borrowings from foreign markets and raising of capital by issue various securities such as shares debentures, bonds, etc . The market where securities are traded known as Securities market.

It consists of two main different segments namely primary and secondary market.

1. Primary Market
2. Secondary Market

Primary Market

This is a market for new issues or new financial claims. Hence, it is also called a New Issue Market. The primary market deals with those securities that are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. There are three ways by which a company may raise capital in a primary market: (i) Public issue, (ii) Right issue and (iii) Private placement.

Secondary Market

The market in which securities are traded after they are initially offered in the primary market is known as secondary market. The secondary market is also known as the stock market or stock exchange. It is a market for the purchase and sale of existing securities. It helps existing investors to disinvest and fresh investors to enter the market.It also provides liquidity and marketability to existing securities. This market consists of all stock exchanges recognized by the Government.

Principles of an Islamic financial system

The basic framework for an Islamic financial system is a set of rules and laws, collectively referred to as *shariah,* governing economic, social, political, and cultural aspects of Islamic societies. *Shariah* originates from the rules dictated by the *Quran* and its practices, and explanations rendered (more commonly known as *Sunnah*) by the Prophet Muhammad. Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the *Quran* and *Sunnah*. The basic principles of an Islamic financial system can be summarized as follows:

Prohibition of interest. Prohibition of *riba*, a term literally meaning “an excess” and interpreted as “any unjustifiable increase of capital whether in loans or sales” is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usuary but also the charging of “interest” as widely practiced.

This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined ex post, symbolize successful entrepreneurship and creation of additional wealth whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

Risk sharing. Because interest is prohibited, suppliers of funds become investors instead of creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits.

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.

Prohibition of speculative behavior. An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.

Sanctity of contracts. Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.

Shariah approved activities. Only those business activities that do not violate the rules of *shariah* qualify for investment. For example, any investment in businesses dealing with alcohol, gambling, and casinos would be prohibited.

Islamic financial instruments

Some of the more popular instruments in Islamic financial markets are ***Trade with markup or cost-plus sale*** **(murabaha)**. One of the most widely used instruments for short-term financing is based on the traditional notion of purchase finance. The investor undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated margin. Around 75 percent of Islamic financial transactions are cost-plus sales.

Leasing (ijara). Another popular instrument, accounting for about 10 percent of Islamic financial transactions, is leasing. Leasing is designed for financing vehicles, machinery, equipment, and aircraft. Different forms of leasing are permissible, including leases where a portion of the installment payment goes toward the final purchase (with the transfer of ownership to the lessee).

Profit-sharing agreement **(mudaraba)**. This is identical to an investment fund in which managers handle a pool of funds. The agent-manager has relatively limited liability while having sufficient incentives to perform. The capital is invested in broadly defined activities, and the terms of profit and risk sharing are customized for each investment. The maturity structure ranges from short to medium term and is more suitable for trade activities.

Equity participation **(musharaka)**. This is analogous to a classical joint venture. Both entrepreneur and investor contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the operation in varying degrees and agree to share the returns (as well as the risks) in proportions agreed to in advance. Traditionally, this form of transaction has been used for financing fixed assets and working capital of medium- and long-term duration.

Sales contracts. Deferred-payment sale *(bay mu'ajjal)* and deferred-delivery sale *(bay'salam)* contracts, in addition to spot sales, are used for conducting credit sales. In a deferred-payment sale, delivery of the product is taken on the spot but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in installments, provided there is no extra charge for the delay. A deferred-delivery sale is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market.