

ISLAMIC FINANCIAL INDUSTRY: A STUDY OF GUIDING PRINCIPLES

Dr. Riyaz Ahmad Sheikh
Assistant Professor, Department Islamic Studies
Islamic University of Science and Technology, Awantipora, J&K (INDIA)

Abstract- Financial system from Islamic perspective is now a well-known spectacle and has arisen as one of the most imperative industries worldwide. Islamic financial industry comprises a progressively diverse range of institutions, including commercial and investment banks, mutual insurance and investment companies. The Islamic finance industry is based on four major principles, explicitly referred to in the Qur'an, hadith and fiqh (jurisprudence). These principles are: La-Riba (no-interest), La-Gharar (no-uncertainty), La-Maisir (no-speculation), and La-Haram (no-unlawful). Islamic banking is branded for its interest free concept and operates in many countries including Bahrain, Pakistan, Jordan, Iran, Sudan, United Kingdom, Singapore and Malaysia. Islamic banking and finance have undergone rapid transformation and growth from an industry striving to gratify the Muslim community needs. Over recent decades the Islamic financial industry has emerged as one of the fastest growing industries and has spread to all corners of the globe, receiving wide acceptance from Muslims and non-Muslims. Therefore, responding to the need, scholars of shari'ah developed an alternate system of banking and finance under the guiding principles of fiqh al-ma'amalat (Commercial Jurisprudence) which, considerably, differs from the Western or conventional system. The former is strictly engrossed in the shari'ah and latter is purely a human workout. Keeping in view the speedy canvas of the industry in also important to have a study of the basic principles which governs the industry. Thus, the present study is a humble attempt to study the Islamic financial industry along with its governing principles. This article consists of two sections. The first section discusses the concept or phenomenon of Islamic financial system. The second portion of the paper discusses the principles governing the Islamic finance.

Key words: Shariah, Riba, Mudarabah, Musharakah

Methodology and data base

To have a stable foundation and to carry out the work with an objective analysis, the research follows an interdisciplinary approach along with both qualitative and quantitative methods were also incorporated to ensure the objectivity.

Though much of the literature is not available on the subject, but data from books, journals, periodicals and online material conducted by different organisations and NGOs were taken into account to have a stable foundation.

Principles of Islamic financial system

Islamic Finance is growing very rapidly across the world, becoming very popular among Muslim countries and as well as in most of the western countries because of the growing number of Muslims in those countries. Many countries in the world are now experiencing a dual banking system, where the banks are involved in an alternative form of banking along with conventional banking.¹ Muslims find it as the biggest challenge in the economic field in order to reform their financial institutions, and bring them according to their religious belief and traditions. In an environment where the system of all financial institutions is based on interest, it seemed to be impossible to form such a structure of financial system which is completely an alternative form of banking. Islamic banking is commonly defined as a form of banking system which operates without the norm of interest.

Islam has a set of goals and values encompassing all aspects of human life, including social, economic and political issues. It is not a religion in the limited sense of the word, interested only in salvation in the hereafter; rather it is a religion that organizes one's entire life. Economic or financial aspect of our life is no way ignored or neglected one.² The first and foremost principle emphasized by the holy Quran with repeated stress is that all natural means of production and resources which subscribe to man's living have been created by Allah (S.W.T) It is He who made them as they are and set them to follow the laws of nature that make them useful for man. It is He who allowed man to exploit them and placed them at man's disposal.³ Islamic finance was practiced predominantly in the Muslim world throughout the middle Ages, in Spain and the Mediterranean and Baltic States, fostering trade and business activities with the development of credit. There were ways through which the creed of Islam reached to the widespread expanses; Muslim merchants became indispensable middlemen for both hurrying the message of Islam and simultaneously giving the concept of trade and its allied activities. It is somehow obvious that, many concepts, techniques, and instruments of Islamic finance were later adopted by European financiers and businessmen.

¹Aqdas, A., K (2009) 'Islamic Banking is a mere myth' [on line] Available at; <http://archives.dawn.com/archives/67526> [Accessed 8th August 2018]

²Mawdudi, Syed AbulA'ala. (2009). *The Islamic Way of Life*. (Tr.), Khurshid Ahmad and Khuram Murad. New Delhi-Markazi Maktaba Islami Publishers, pp.9-58.

³Al-Quran, ii,29; vii,10; xiii,3; xiv,32-34; lvi, 63-64.

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.⁴ Further elaboration of the rules is provided by Muslim scholars in *fiqh al-mamulaat* within the framework of the Quran and Sunnah. There are antithetical views among scholars for some there are seven guiding principles but the present study will delineate and gave a discourse of three main or the basic governing principles of Islamic financial system;

Riba (Interest/usuary) 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.

Riba can be roughly translated as "Usury" or unjust, exploitive gains made in trade or business. The word "Riba", in Arabic language, literally means an "increment' or addition". In Islamic Fiqh the term *riba* has a special meaning. Riba in Islamic Banking is an unjustified increment in borrowing or lending money, paid in kind or in money above the amount of loan, as a condition imposed by the lender or voluntarily by the borrower. This definition of Riba Islamic Finance is derived from the Quran and is unanimously accepted by all Islamic scholar there are two types of Riba, identified to date by these scholars namely 'Riba An Nasiyah' and Riba Al Fadl'.

- 'Riba An Nasiyah' is defined as excess, which results from predetermined interest (*sood*) which a lender receives over and above the principle (*RasulMaal*)
- 'Riba Al Fadl' is defined as excess compensation without any consideration resulting from a sale of goods. 'Riba Al Fadl' will be covered in greater detail later.

During the dark ages, only the first form (*RibaAnNasiyah*) was considered to be Riba. However the Holy Prophet also classified the second form (*Riba Al Fadl*) as Riba. The meaning of *riba* Islamic finance has been clarified in the following verses of Quran:

- "O those who believe fear Allah and give up what still remains of the Riba if you are believers. But if you do not do so, then be warned of war from Allah and His Messenger. If you repent even now, you have the right of the return of your capital; neither will you do wrong nor will you be wronged."⁵

These verses clearly indicate that the term Riba Islamic finance means any excess compensation over and above the principal which is without due consideration. However, the Quran has not altogether forbidden all types of excess; as it is present in trade as well, which is permissible. The excess that has been rendered haram in Quran is a special type termed as Riba.

In the dark ages, the Arabs used to accept Riba as a type of sale, which unfortunately is also being understood at the present times. Islam has categorically made a clear distinction between the excess in capital resulting from sale and excess resulting from interest. The first type of excess is permissible but the second type is forbidden and rendered haram.⁶

Islam, like other monotheistic religions, condemns and prohibits *riba*. The prohibition of *riba* in Islam is given in strong and clear-cut terms. The Qur'an says "But God has permitted the sale and forbidden the Riba";⁷ and, "God destroys/eliminates the Riba";⁸ and, "O ye who believe, fear God and quit what remains of the Riba if ye are indeed believers; but if ye do it not, take notice of war from God and His Messenger."⁹ No other sin is prohibited in the Qur'an with such a notice of war from God and His Messenger! The Traditions of the Prophet Muhammad contain several statements that condemn *riba* and consider its practices as one of the gravest sins that invoke a curse or wrath from God. In one of the Sayings, the Prophet mentions: "The Wrath of God is on the taker of Riba, its giver, its writer and its two witnesses." It can be regarded as the prohibition of interest: Riba is an Arabic word that means increment or increase. But the Qur'an did not mean any increase. It refers to a specific sort of transaction; the *riba* that was practiced and known among the Arabs and other nations at the time of revelation. For this reason, the reference in the Qur'an came with the article "the." "The" *riba* means a specific transaction known to the audience. It was done in one of two ways: deferring an already existing and due debt to a new maturity, provided the amount of debt is increased, or giving a loan that is due for repayment in a future date with an increment. In other words "the *riba* refers to an increase in the amount a debtor owes his creditor due to the passage of time. This understanding is based on the text of the Qur'an itself, which states: "But if ye repent ye shall have your principal, doing no injustice (against others) and no injustice is done against you."¹⁰ This verse has two important indications. First, it defines *riba* as any increment above the principal of a debt or a loan; and second, it describes such increments as unjust. The exclusion of profit, being another kind of increase that is an increase in the amount received for a good over its cost, is given by Verse 2:275: "But God made sale permissible."¹¹

To be exact, regarding financial transactions, *riba* is defined as any increment above the principal of a loan that increases as a function of time—that is, interest. Both legally and financially, interest is defined as an increment paid by the debtor to the

⁴ The term *Shari'ah* means "way" or "path"; it is the legal framework within which the public and private aspects of life are regulated for those living in a legal system based on Islam. *Shari'ah* deals with all aspects of day-to-day life, including politics, economics, banking, business law, contract law, sexuality, and social issues. *Shari'ah* originates from the rules dictated by the Quran and its practices, and explanations rendered (more commonly known as Sunnah) by the Prophet Muhammad.

⁵ *Al Baqarah* 2:278-9

⁶ <http://www.aims.education/study-online/riba-in-islamic-banking-and-finance/>

⁷ Qur'an at 2:275

⁸ Qur'an at 2:276.

⁹ Qur'an at 2:278–79

¹⁰ Qur'an at 2:279.

¹¹ Qur'an at 2:275.

creditor for granting a loan or for extending the maturity of an existing debt. The shariah does not recognize a counterpart for this increment. Consequently, once a debt is created, any payment above the principal of the debt is interest and is “Prohibited Riba” according to the terminology of the Qur’an

PLS (Profit and Loss Sharing)

Profit and loss sharing financing is a form of partnership, where partners share profit as well as loss on the basis of their capital share and effort. Unlike conventional financial system, there is no guaranteed rate of return. Islam supports the view that Muslims do not act as nominal creditors in any investment, but as partners in the business (that is, essentially equity based financing). There are two varieties of Profit and Loss Sharing used by Islamic banks -- *Mudarabah* (مضاربة) and *Musharakah* (شراكة or مشاركة)¹²

Mudarabah in Islamic Banking:

Mudarabah in Islamic banking may be defined as follows: If investment made from one partner and services from other partner, it is called Mudarabah. Investor in Mudarabah Contract is called “Rabb-ul-Mal” and the working partner is called “Mudarib” and investment is called “Ras-ul-Mal”. It is basically a partnership in profit whereby one party provides capital, which is called Rab-ul-Maal. And the other party provides labor/management which is called Mudarib.¹³

Let us have a look at these basic principles before entering the details:

1. Financing through musharakah and mudarabah does never mean the advancing of money. It means to participation in the business and in the case of musharakah, sharing in the assets of the business to the extent of the ratio of financing.
2. An investor/financier must share the loss incurred by the business to the extent of his financing.
3. The partners are at liberty to determine, with mutual consent, the ratio of profit allocated to each one of them, which may differ from the ratio of investment.

However, the partner who has expressly excluded himself from the responsibility of work for the business cannot claim more than the ratio of his investment.

4. The loss suffered by each partner must be exactly in the proportion of his investment.¹⁴

PROOF OF MUDARABAH:

Hazrat Khadijah Kubra (RTA) used to give capital for business and our Holy prophet Muhammad (SAW) do business from her capital.

TYPES:

In Mudarabah Mutlaqa (Un-restricted Mudarabah) no restriction from the Rabb-ul-Mal regarding the business. However In Mudarabah Muqayyada (Restricted Mudarabah) some restrictions implemented from the Rabbul Mal (Investor)

RULES OF PROFIT AND LOSS:
Profit may be distributed at any agreed ratio. In case of loss, all loss will be borne by the “Rabb-ul- Mal”. Mudarib’s share of profit will not be given to Mudarib.

Basic instruments include cost-plus financing (murabaha), profit-sharing (mudaraba), leasing (ijara), partnership (musharaka), and forward sale (bay’ salam). These instruments serve as the basic building blocks for developing a wide array of more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets.¹⁵

Proscription of hypothetical behaviour and Shariah-approved activities.

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.¹⁶

Only those business activities that do not violate the rules of shariah qualify for investment and also having its worse impact to society or have a threat to the social responsibility or social order. They include:¹⁷

- I. Pornography.
- II. Prostitution.
- III. Alcohol.
- IV. Pork.
- V. Drug.

¹² Muhammad Anwar, “ Development of Mudarabah Instruments: Understanding Their Profitability, Securitization And Negotiability Aspects”, IIUM Journal of Economics and Management, Volume: 9 (2001), Issue: 2, pp. 165-186.

¹³ <https://www.islamicfinancenews.com/glossary/mudarabah>

¹⁴ http://islamicdatabase.org/sites/default/files/islam_modes_of_finance.pdf

¹⁵ <https://kantakji.com/media/8643/islamic-finance-system.pdf>

¹⁶ Nomani, Farhad; Rahnama, Ali (1994). *Islamic Economic Systems*. New Jersey: Zed books limited. pp. 99–101.

¹⁷ <http://www.iflr.com/Article/1984844/The-three-principles-of-Islamic-finance-explained.html>

Conclusion

Din-i-Islam has a set of goalmouths, values and standards encompassing all aspects of human life whether it is social, political and economic. Since all the aspects of life are symbiotic and Islamic way of life being a consistent whole, its goals and values in one field determine the goals and values in the other fields as well. Consequently, the said interdependency is to be put into consideration when it comes to economic participation and financial engagements. Therefore, responding to the need, scholars of shari'ah developed an alternate system of banking and finance under the guiding principles of fiqh al-ma'amalat (Commercial Jurisprudence) which, considerably, differs from the Western or conventional system. The former is strictly engrossed in the shari'ah and latter is purely a human workout. The Islamic finance industry is based on four major principles, explicitly referred to in the Qur'an, hadith and fiqh (jurisprudence). These principles are: La-Riba (no-interest), La-Gharar (no-uncertainty), La-Maisir (no-speculation), and La-Haram (no-unlawful). The guiding or governing principles of Islamic financial industry is having two folded aims one is to fulfil the commandments of Allah (s.w.t) and other aim and objective is to keep the social drapery or social order in balance where every person irrespective of sex, race or colour etc. could exhale spontaneously and self-sufficiently. Since Islamic financial industry is going bigger and more sophisticated, standardization of the industry is going more and more important for further development of industry. Since Islamic financial products are governed by unique rules, restrictions and requirements regarding business and investment which are different to mainstream conventional finance industry. Prevailing financial systems are predominantly based on the conventional legal system which may or may not have provisions for handling special treatment of Shariah rules, the development of supportive legal and tax codes, and of a homogeneous regulatory framework based Shariah law which is crucial for the success of Islamic financial service industry. Needless to mention in the lieu of conclusion that Islamic financial industry is in growing stage and many Muslim as well as Non-Muslim countries are investing in the Islamic financial sector due to its enormous attractions and qualities.

Bibliography

1. Aqdas, A., K (2009) 'Islamic Banking is a mere myth' [on line] Available at; <http://archievs.dawn.com/archives/67526> [Accessed 8th August 2018]
2. Albalawi, Suliman Hamdan (September 2006). "Banking System in Islamic Countries: Saudi Arabia and Egypt. A Dissertation Submitted to the School of Law and the Committee on Graduate Studies of Stanford University"
3. Mawdudi, Syed AbulA'ala. (2009). *The Islamic Way of Life*. (Tr.), Khurshid Ahmad and Khuram Murad. New Delhi- Markazi Maktabs Islami Publishers,
4. Muhammad Anwar, " Development of Mudarabah Instruments: Understanding Their Profitability, Securitization And Negotiability Aspects", IIUM Journal of Economics and Management, Volume: 9 (2001), Issue: 2.
5. Naqvi, S.N.H. 2000. Islamic banking: An evaluation. *IIUM Journal of Economics and Management* 8 (1)
6. Nomani, Farhad; Rahnema, Ali (1994). *Islamic Economic Systems*. New Jersey: Zed books limited.
7. Al-Qur'an 2: 2
8. Al-Qur'an 2:275
9. Al-Qur'an at 2:276.
10. Al-Qur'an at 2:278-79
11. Al-Qur'an at 2:279.
12. Al-Qur'an at 2:275.

Web Source

1. <https://www.islamicfinancenews.com/glossary/mudarabah>
2. http://islamicdatabase.org/sites/default/files/islam_modes_of_finance.pdf
3. <https://kantakji.com/media/8643/islamic-finance-system.pdf>
4. <http://www.iflr.com/Article/1984844/The-three-principles-of-Islamic-finance-explained.html>
5. <http://www.aims.education/study-online/riba-in-islamic-banking-and-finance/>