

Islamic Finance- An Elixir to Financial Crisis

Dr. Priya Rao

Assistant Professor, Jazan University, Kingdom of Saudi Arabia.

spmafrica@gmail.com

Abstract- This paper provides the general idea on Islamic Finance, covering the history and the legislative framework. The paper also covers various aspects of Islamic Finance, and variation of Islamic Banking from conventional banks. The paper concludes that Islamic Finance is panacea for financial crisis and has proved to be one of the safer approaches as it seeks to reduce concentration of wealth in a few hands, which may be detrimental to society.

Paper Type- General

Key Words- Islamic Finance, Shariah, financial crisis, conventional banking

INTRODUCTION

The beliefs of Islam encompass all aspects of a Muslim's life, determining the articles of their faith and the relationships between man and God, and between human beings. They also determine their moral and behavioral code, as well as giving the framework for their daily activities. Islamic law or Shariah – as revealed in and derived from the Quran and Sunnah (the sayings and practices of the Prophet Muhammad) – governs all economic and social activities and undertakings of Muslims.

That legislative framework of Islam depends on four main sources:

1. The Holy **Quraan**: which is the literal words of Allah (may He be glorified and exalted);
2. **Sunnah**: which refers to saying, actions, and approvals of the prophet and Allah's messenger Mohammad (peace be upon him);
3. **Ijmah**: which refers to the consensus that has been reached by Islamic scholars on a particular issue throughout the history; and
4. **Qiyas**: which means analogy and it refers to rulings on issues where there is no explicit guidance in either the **Quraan** or the **sunnah** and, therefore are derived by qualified scholars with preference to rulings related to similar issues.

LITERATURE RESEARCH

McKenzie (2011), Shariah-compliant assets grew from USD 1504 billion in the mid-1990s to around USD 551, 749, 947, and 1041 billion in 2006, 2007, 2008, and 2009, respectively.

Rarick, Charles A; Han, Thaung (2010) concluded that Islamic finance has an important role to play in the global financial system, and that, it is not a viable substitute for traditional financial management.

Muhammad Umer Chapra (2009) had a view that risk-sharing along with the availability of credit for primarily

the purchase of real goods and services and restrictions on the sale of debt, short sales, excessive uncertainty (*gharar*), and gambling (*qimar*), which Islamic finance stands for, can help inject greater discipline into the system and, thereby, substantially reduce financial instability.

Muhammad Umer Chapra(2009) concluded that one of the major causes of the crisis is the lack of adequate market discipline in the financial system.

M. Mansoor Khan (2008) hold that Islamic banking and finance industry has been making breakthrough improvements to become a truly viable and competitive alternative to conventional systems at the global level. Islamic banking and finance institutions have acquired booming grounds in the Middle East, South East and South East Asia.

Gordon Platt Regional Report (2007) said that International Islamic Finance is no longer a niche market catering to Muslims only but is "increasingly a mainstream component of the global banking system"

GROWTH ISLAMIC FINANCE

Shariah law is the legislative framework that regulates all aspects of life both private and public and accordingly Islamic finance means that all financial transactions are conducted in accordance with the **Shariah** law. The evolution of Islamic finance have gone through three phases: a) the fledging years (1975-1991); the globalization era (1991-2001) and post September 11, 2001. The Islamic banking and finance discipline is nearly four decades old. The conceptual developments of Islamic banking took cognizance in late 1940s

The growth of Islamic finance has been accelerating ever since, in terms of the number of countries in which it operates. In recent years, the industry has attracted a number of Western multinational financial institutions.

"In the UAE, Islamic banking assets grow to 20 per cent of the total banking sector in 2012 from an estimated 18 per cent in 2011, a banking expert has mentioned. According

to recent data of Bloomberg, Global sales of Shariah-compliant bonds jumped to US\$36 billion 2012, just shy of 2011's full-year record of US\$36.7 billion. In the third quarter of 2012 USD 40 billion sukuk was issued globally, comparing with the previous year same period the figure almost doubled. This takes the total of sukuk issued during the first nine months of the year to a record USD 109 billion, up 69% from the same period last year. Still, the value of sukuk sold this year compares with US\$2.9 trillion of international bonds sold in 2012, according to data compiled by Bloomberg is not reflecting the market share of Muslim population in the world.

At the time being Islamic financial assets are valued at US\$1.3 trillion. S&P expects the industry to grow 20% annually over period of 2011-2015 "**

*Source: Global Islamic Finance Magazine 2012

ISLAMIC FINANCE & CONVENTIONAL BANKING

Islamic finance is fundamentally different from the conventional banking models as it is based on a profit and loss structure and the prohibition of *riba'* (interest). This structure requires that the financial institution invest with the client in order to finance the client's transaction rather than lend money to the client.

Due to the inherent risk involved in any investment, the financial institution is entitled to profit from the financial transaction. This is a stark contrast to modern finance in which interest is one of the key methods by which banks make money through their products, such as mortgages and personal loans. Despite its differences to its western counterparts, Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of *shariah*, known as *fiqh al-muamalat* (Islamic rules on transactions). Unlike ordinary commercial banks whose operations are based on interest, Islamic banks operate an interest-free system and are guided by the common principle that depositors, instead of receiving a fixed return in the form of interest, share the risk of investment and take part of the resulting profits or bear part of the losses.

Some of the people carry the wrong assumption, especially those who are not conversant with the principles of Shari'ah and its economic philosophy that abolishing interest from the banks and financial institutions would make them charitable, rather than commercial, concerns which offer financial services without a return.

According to Shari'ah, interest free loans are meant for cooperative and charitable activities, and not normally for commercial transactions, except in a very limited range. For the commercial financing, the Islamic Shari'ah has a different set-up for that purpose. The principle is that if the person extends money to another person he has to decide whether he wishes to help the opposite party or he wants to share his profits. If he wants to help the borrower, he must restrain him from any claim to any additional amount. His principal will be secured and guaranteed, but no return

over and above the principal amount is legitimate. But if his intention for lending the money is to share the profits earned by the other party, he can claim a stipulated proportion of profit actually earned by him, and must share his loss also, if he suffers a loss. If financing is meant for a commercial purpose, it can be based on the concept of profit and loss sharing, for which *musharakah* and *mudarabah* have been designed since the very inception of the Islamic commercial law.

It is thus obvious that exclusion of interest from financial activities does not necessarily mean that the financier cannot earn a profit.

In some sectors where financing on the basis of *musharakah* or *mudarabah* is not workable or feasible the contemporary scholars have suggested some other instruments like *murabahah*, *ijarah*, *salam* or *istisna*.

ISLAMIC FINANCE- ONE OF THE SAFER APPROACHES TO AVOID FINANCIAL CRISIS

Financial crisis is the combined influence of **greed** to maximise profit, wealth and consumption by any means in keeping with the mores of the prevailing secular and materialist culture second is **market discipline** which is expected to exercise a restraint on leverage, excessive lending and derivatives and reform of the system's structure along with **prudential regulation and supervision** appropriately designed to prevent crises, achieve sustainable development and safeguard social interest. **Misleading contracts and speculation** are also the religious reasons behind the global financial crisis.

For ensuring the health and stability of the global financial system we need to adopt some of the elements of the Islamic system, which are also a part of the western heritage. These are:

1. The proportion of equity in total financing needs to be increased in comparison of debt.
2. To avoid speculation and gambling credit needs to be confined primarily to transactions that are related to the real sector. So that credit expansion moves more or less in step with the growth of the real economy and.
3. Credit does not exceed beyond the ability of the borrower to repay.
4. Full transparency of the debt instruments is must.
5. Regulated Derivatives market and elimination of gambling.
6. To avoid systematic risk financial institutions, and commercial banks, need to be properly regulated and supervised
7. Proper arrangements for subprime borrowers to make them credit available at affordable terms and to enable them to buy a home or to establish their own micro business units.
8. Support to the distress debtors.

Islam has, however, laid down certain conditions that would help prevent excessive expansion of debt. Some of

these are:

The asset which is being sold or leased must be real :leads to eliminate most of the speculative transactions which involve *gharar* (excessive uncertainty) and *qimār* (gambling).

The seller must own and possess the goods being sold or lease: will help to ensure that the seller (or lessee) also shares a part of the risk to be able to get a share in the return.

The *sharī_ah* has made an exception to this rule in the case of *salam* and *istisnā* where the goods are not already available in the market and need to be produced before delivery.

The transaction must be a genuine trade transaction with full intention of giving and taking delivery; will help to eliminate speculative and derivative transactions

The debt cannot be sold and thus the risk associated with it cannot be transferred to someone else. It must be borne by the creditor himself. This helps to prevent the debt from rising far above the size of the real economy.

Islamic Banks hold more capital than conventional banks and performed better during the global financial crisis. Islamic Financial transactions are accompanied by productive activity and there is no divorce between financial and real.

CONCLUSION

Islamic finance had started to become a preferable source of finance not only for Muslims but for non-Muslim investors as well due to its ethical nature. That is, non-Muslim investors started to view investing in *Shariah*-compliant products as a form of ethical and socially responsible investing.

The Islamic financial system can make a valuable contribution to the international financial system. The beliefs and the values which are incorporated in Islamic finance like greed (*hirs*), extravagance (*isrsaf*) , misleading contracts (*gharar*) and *qimār* will surely help in better risk management. In terms of governance Islamic Financial Institutions have an extra layer of governance in *Shariah* supervisory board.

The Islamic finance emphasizes fairness and make sure that everyone involved in a transaction makes informed decisions and is not misled or cheated.

On a macro-economic level, the Islamic finance aims at social justice and the economic prosperity of the whole community; for example, specific *Shariah* rulings seek to reduce concentration of wealth in a few hands, which may be detrimental to society. The Islamic financial system can help where the world needs new ways of thinking about finance and the risks it involves.

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