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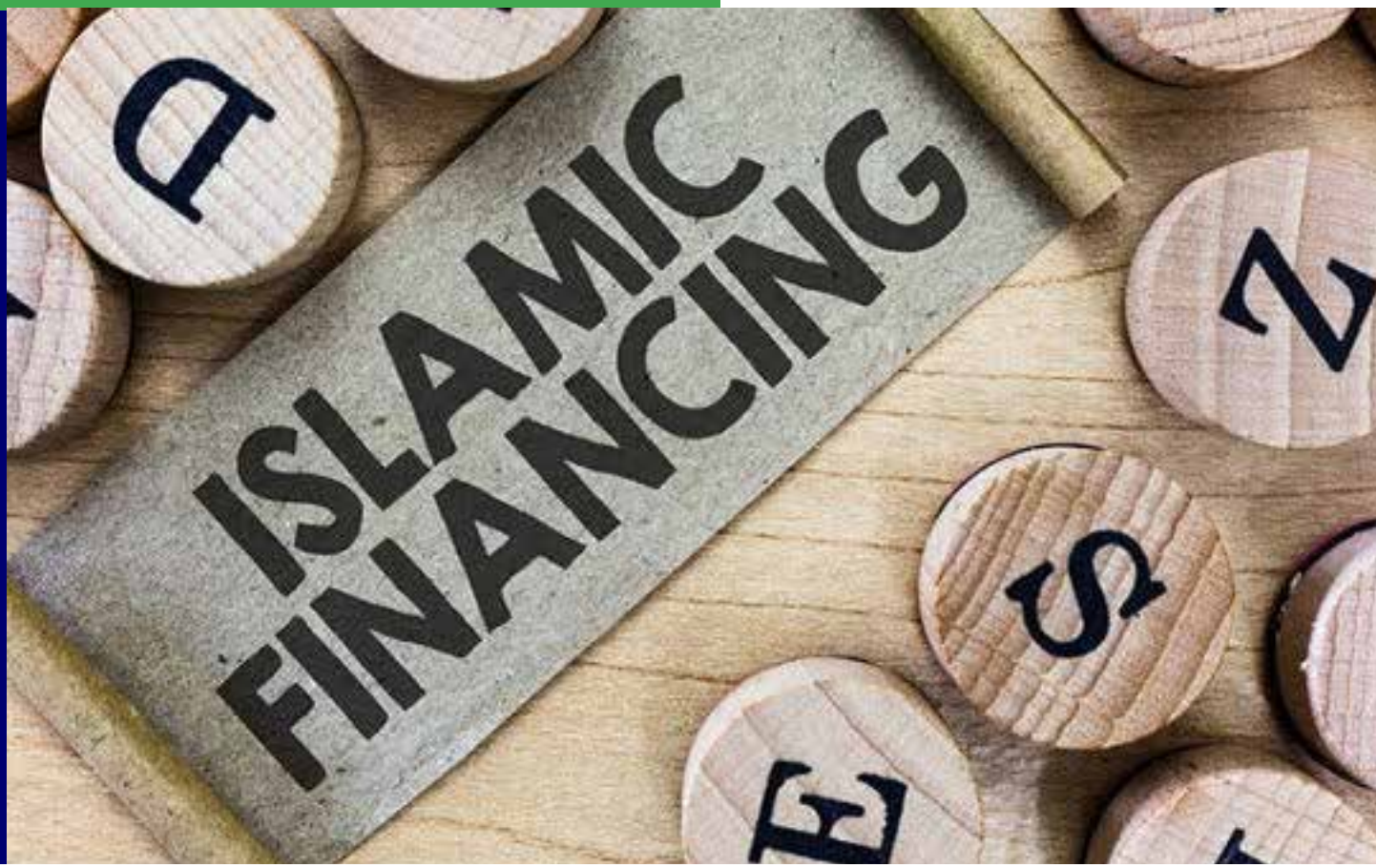
# STUDY GUIDE




# ISLAMIC FINANCIAL SYSTEM PART 1

DR HUSSAIN HAMED HASSAN

From the series:
Islamic Financial System

COURSE OUTLINE

## Course Topics

1. Basic characteristics of Islamic finance
2. How does an Islamic bank operate?
3. Islamic finance is based on equity
4. Benefits of an equity based financial system
5. How does an Islamic bank mitigate its losses without any interest or surety?
6. Islamic banks achieve profit rates similar to conventional banks
7. Economic crisis and slowdown – effects on conventional and Islamic financial systems
8. Rate of Interest or Rate of Profit – what's the difference?
9. Communication of risks to the depositors
10. Shukook (Islamic bonds)
11. Application of funds by an Islamic bank
12. Lease according to the Islamic financial system

# COURSE OUTLINE

## Course Objectives

1. Understanding the impact of Ribaa (interest) on the economy
2. Learning about the operation of the Islamic financial system
3. Learning about and understanding the benefits of the Islamic financial system on the economy

## Question & Answer Bucket

## Transcripts

## Assessment

Multiple Choice Questions
Match the Columns
True or False

## Course Duration

| | | |
|---|---|---|
| Video | – | 2 hours 20 min |
| Study Guide | – | 45 min |
| Assessment | – | 10 min |
| Total Duration | – | 3 hours 15 min |

Lesson 1

# ISLAMIC BANKING

# 1 Basic characteristics of ISLAMIC FINANCE

The Islamic Financial system is based upon what has been revealed in the Qur'an, the Sunnah, and their interpretations made by qualified Muslim jurists.

## i INVESTMENT AND WORK AS AN OBLIGATION

Islam considers investment and work as an obligation, meaning either invest your income yourself or have someone knowledgeable and experienced help you out so that your income isn't stagnant, but instead you produce more goods and services and benefit yourself and the society.

Therefore, Islamic financing is about adopting the principle of partnership between those who have money (financial liquidity) but not having the necessary experience or qualifications with those who are qualified and experienced but lack the financial means.

## ii A TYPE OF LIMITED LIABILITY PARTNERSHIP

The risk of loss will be shared by both the partners – the investor and the investee. The investors responsibility is limited to the money they contribute, and the investee would be responsible for the provision of their expertise, experience, knowledge, and labour.

The profit-sharing agreement can be decided as agreed by both the parties, 50-50, 60-40, 80-20 etc., and in the case of loss, the financier / investor risks his capital, while the investee risks their expertise, knowledge, labour, and time.

## iii RISK SHARING AND NOT RISK SHIFTING

Compared to the conventional finance system, Islamic financing is based on the principle of risk sharing rather than risk shifting.

Risk sharing is when the loss will be borne by both the parties – the investor and the investee.

For example, if the Islamic bank finances a client seeking finances for one of his projects, the bank would agree with the customer on terms of profit distribution and its percentage but would also share the risk of loss at the same time.

Risk shifting is when the loss will only be borne by the investee / borrower.

For example, when a conventional / commercial bank finances a client, it comes with a pre-agreed condition that he would be financed in the form of a loan with a pre-agreed rate of interest that he would provide a guarantee for and be responsible for its return along with the interest regardless of the result of his project. The bank does not bear the risk of loss in any scenario.

# 2 How does an ISLAMIC BANK OPERATE?

When an Islamic bank starts operating, there is no lending-borrowing relation between depositors and the Islamic bank, but instead it has shareholders depositing, paying capital and investing their capital in one common pool with the depositor's funds together like any partnership.

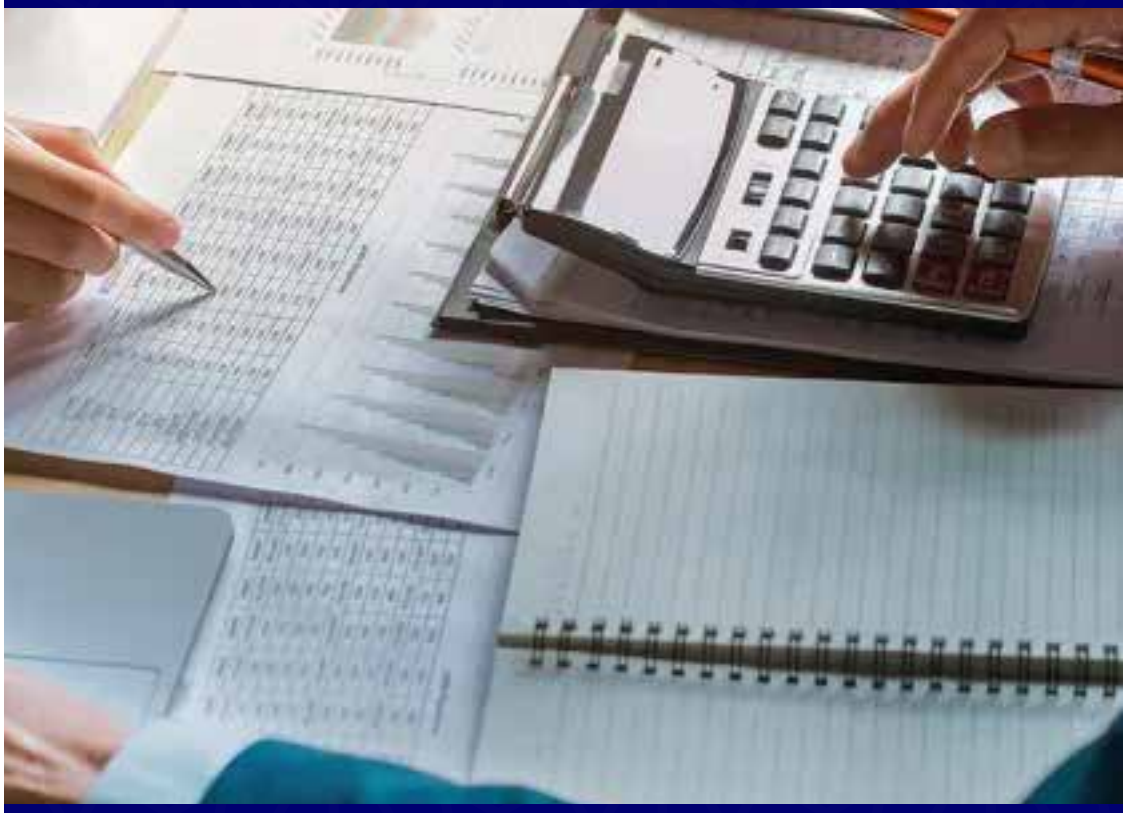
If there is profit, they will share it as agreed, and in the case of loss too, they will share this loss together proportionately (the customer and the bank).

In comparison to a conventional bank, wherein the entire risk of loss is upon the customer and the bank is only focused on getting back its loan with the interest percentage as profit.

Islamic financing is socially structured to help those who have ideas, knowledge, experience, to invest in new projects for the development of the workers and the economy of the country.

Lesson 2

# FINANCE
# CHARACTERISTICS



# 3 Islamic finance IS BASED ON EQUITY

The Islamic financial system is an equity based financial system and not debt financing, because the Shariah does not permit financing a debt with Ribaa (interest).

When an Islamic bank finances a customer for a certain project, it does not give loan with interest, but instead it gives them the capital to invest in the project after doing the due diligence of going through the carried out visible market study that outlines the performance and expected estimates of the particular project.

The reason behind this financing being named as equity-based financing is that since the capital is owned by the bank, it will be the owner of the project when the money is converted into assets or the project is established, but the Mudarib (customer) will share the profits because of his experience and knowledge.

# 4 Benefits of an equity BASED FINANCIAL SYSTEM

In an equity based financial system (like the Islamic financial system), since the bank pays the capital invested in the project, the project is owned by the bank.

Therefore, in case the customer goes bankrupt, commits misconduct, or defaults towards the bank, the Islamic bank will not be at a loss because the project is owned by the bank and not the customer.

But if the same customer goes to a conventional bank (not based on equity sharing), he gets a loan from the bank with a pre-agreed rate of interest and is free to do whatever he wishes with the loan as long as he pays back the bank its due on time.

The relationship of the customer with a conventional bank is that of a creditor (bank) and a debtor (customer), therefore the project established by the customer in this case would be owned by him / her and not the bank.

But, in this case if the debtor defaults or become bankrupt, the bank may not be able to recover the loan completely or even a part of it because the project is owned by the customer and not the bank. And in some cases, even if the banks make use of the collateral and guarantees on those assets, they may have to share the sale proceeds of those assets with the other creditors too, causing the banks to lose money.

# 5 How does an Islamic bank mitigate its losses WITHOUT ANY INTEREST OR SURETY?

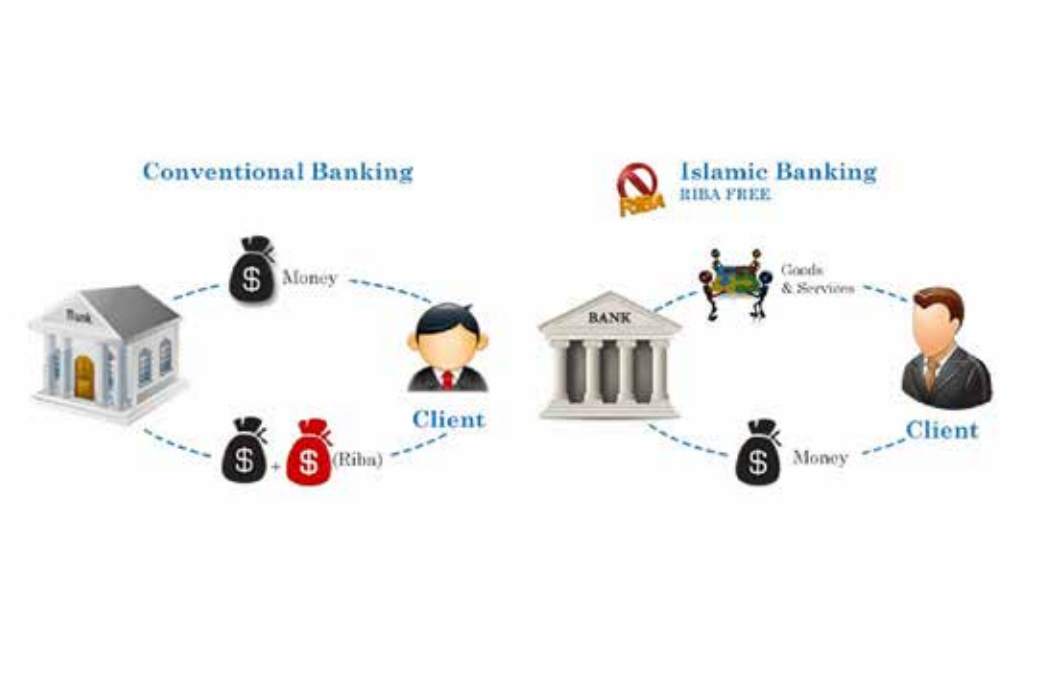
When an Islamic bank or any Islamic financial institution finances a project on Mudarabah basis, they are always advised to ask the customer for his / her feasibility study which has been prepared according to the scientific rules and current market scenario and making use of his previous experience.

It is the bank's responsibility to perform due diligence when it selects a project to be financed. It must take care that it does not finance someone with no experience or expertise of what they are doing, or whose feasibility study does not provide adequate details and projections because the bank is Ameen (trustee) of its depositor's money.

But if the customer (investee) can prove that he abided by the terms and conditions of the agreement, and that the loss caused was due to external reasons (economic crisis, natural disasters etc) beyond his control, then the customer cannot be held solely responsible for the loss, instead the loss would be shared by both the parties (investor and investee).

# 6 Islamic banks achieve profit rates
## SIMILAR TO CONVENTIONAL BANKS

If we are talking about deposits, that the customer will deposit in Islamic bank and some other customers will deposit their money with a conventional bank. Conventional banks base their profit rates on a pre-agreed rate of interest for their customer deposits, while Islamic banks invest their customer deposits in numerous transactions and share the acquired profit with their depositors on a pre-agreed ratio or percentage rather than deal with a pre-agreed fixed interest percentage.



In most cases, the profit achieved and distributed by the Islamic bank to its depositors is much higher or equal to what the conventional banks promise with respect to the interest ratio, because if the Islamic financial system is not able to provide benefits to its customers similar to those that conventional banks provide, then they would definitely prefer to deal with the conventional banking system based on Ribaa (interest).

Lesson 3

# ECONOMIC SLOWDOWN

# 7 Economic crisis and slowdown – EFFECTS ON CONVENTIONAL AND ISLAMIC FINANCIAL SYSTEMS

It is important to differentiate between crisis caused by the financial system and effect of crisis on the financial system.

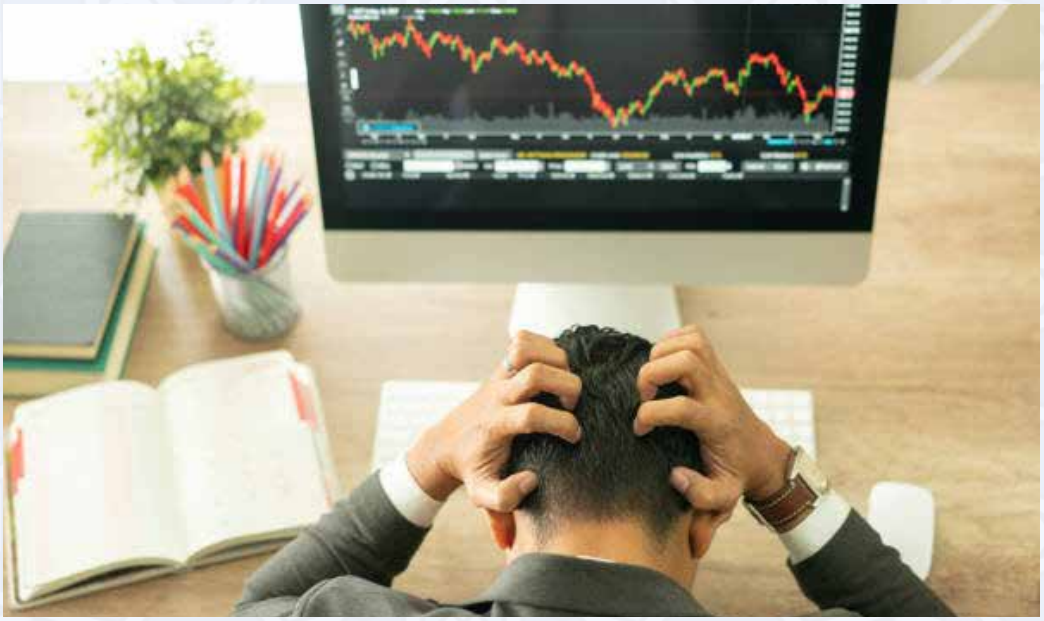
Economic crisis like that of the 2008 economic crisis was not the first one and will not be the last one because the capital economy and the conventional financing is based on the rate of interest, which controls the entire economy and the financial system.

Conventional banks receive deposits on the basis of interest, which they share with their clients and depositors when they utilize the deposits and lend it to the customers.

Since interest is an inherent factor in the capitalist system (interest-based financing), a higher interest rate would cause a crisis because the cost of financing increases.

If the cost of financing increases, people would think twice before asking for investments to start a new business because of the high costs. Also, if the interest rates are high, investors would be more likely to invest in interest-based financing rather than equity-based financing because of better returns without any risk factor, causing recession due to less or no investment in new projects.

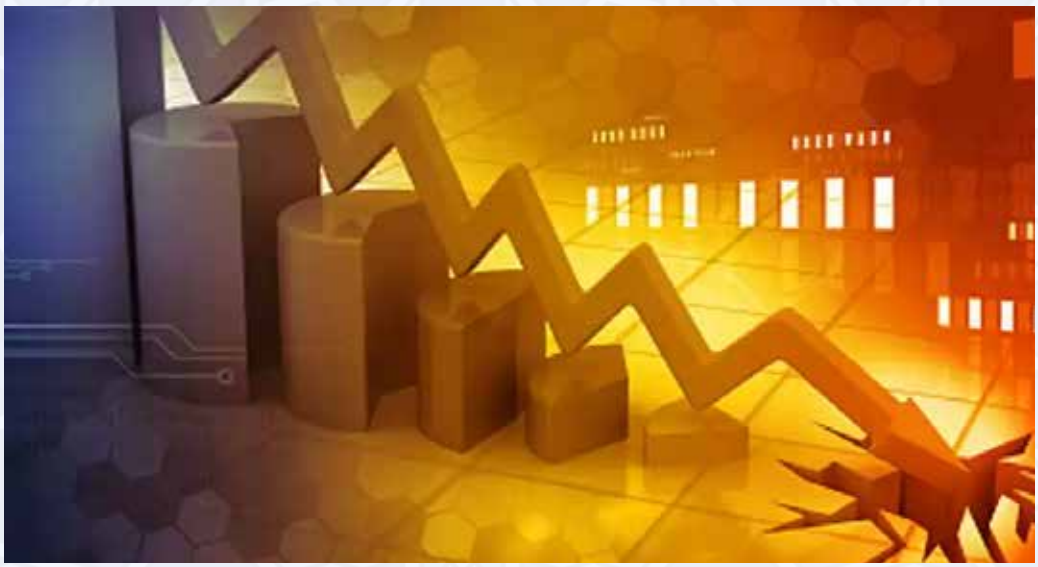
Similarly, if the interest rates are very low, everyone would rush to get loans because of the low financing rates, which would be so bad for the society and the economy (similar to what happened in the 2008 crisis). The banks wanting to make quick profits on the interest rates would not perform due diligence, check credibility and the ability of the borrowers, which would further on be a reason for an economic crisis when these borrowers would default and not be able to pay back the borrowed sum of money.



This sort of an economic crisis or slowdown would not happen if financing were executed according to the Islamic financial system because the Shariah prohibits debt-based financing or dealing with Ribaa (interest), but since it was caused by external factors (conventional financing system), it can have an effect of the Islamic banks and financing institutions too.

Islamic banks receive deposits from companies and conventional banks too, who in the times of crisis withdraw their deposits and investments in the Islamic banks to pay out their depositors, avoid liquidity crisis and bankruptcy.

Since 1929, the world has faced such crisis every seven years to ten years, and when the world faces a crisis, they try to find a remedy for their actions, failing to realise that their remedy too has a side-effect which could be the cause of another crisis – inflation-recession-inflation, and the cycle continues.



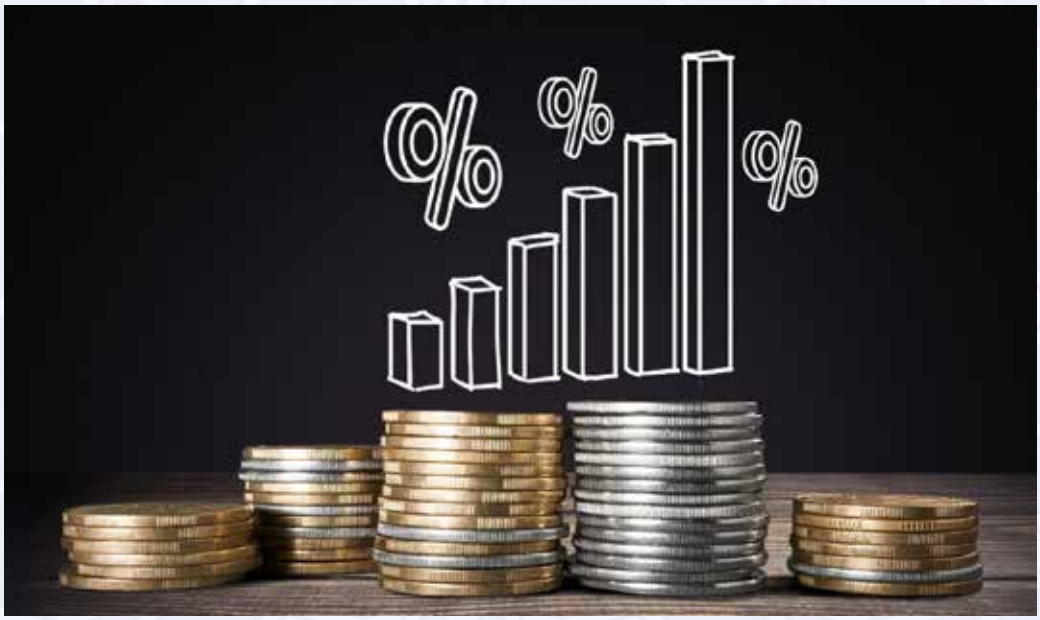
Lesson 4

# FINANCE
# CHARACTERISTICS

# 8 Rate of Interest or Rate of Profit – WHAT'S THE DIFFERENCE?

When one applies for financing through a conventional bank, he / she must agree to a pre-agreed rate of interest which would be added to the original capital whether the investee makes a profit or a loss, because the conventional financial system does not believe in financing without interest.

While on the other hand, Islamic banks provide financing with zero interest because they believe in the principle of equity-based financing. The investee pays only a share of the pre-realized profit on the percentage agreed between the investee and the bank in the event of profit. But, if the investee faces a loss, then he does not have to pay the bank, instead the bank shares the loss with him / her.



# 9 What are DERIVATIVES?

Derivates are also known as futures, options, or short sales, all of which are prohibited by the Shariah because they are transactions based on Ribaa (interest) or Gharar (uncertainty). Any agreement or contract which involves interest or uncertainty is declared as null and void.

## CONDITIONS FOR A VALID AGREEMENT / SALE ACCORDING TO THE SHARIAH

### i SUBJECT MATTER OF THE SALE SHOULD EXIST

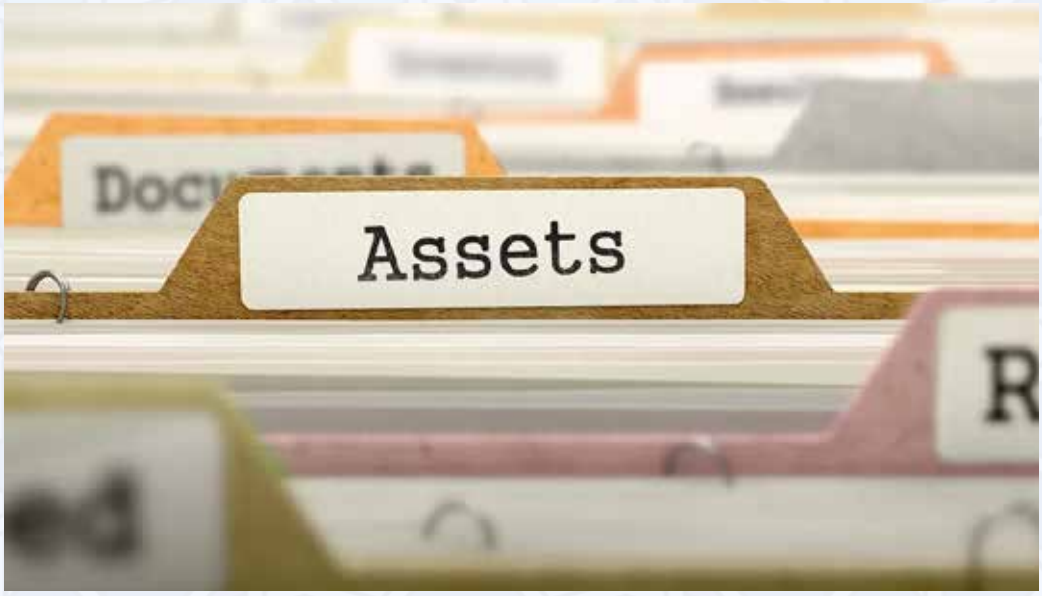
When one enters into a sale agreement, the subject matter of the sale should exist because the price would be paid to the seller. If the asset itself does not exist (example you say, 'I sell to you the fruits of my farm of 2025 for $1000.', but you do not know if your farm would bear fruits in 2025.)

## ii THE SELLER SHOULD OWN THE ASSET

The Prophet (pbuh) said:
**"Do not sell what you don't own."**

The seller should own the assets he wants to sell, because you are not permitted to sell someone else's property (for example, how can you lend me $10 if you do not have $10?).

Ownership or possession does not necessarily have to be physical possession but can be any action that gives you full discretion and power to dispose of an asset.
It can be a key to the asset, a registration certificate etc.



It can also be constructive possession (goods shipped from outside in your name and the ship-man is your agent in taking possession because you have full right to direct him about further action for the goods).

The conventional financial system does not believe in the above conditions, but instead one can even sell what he does not own (short sale).

Short selling is when you borrow some shares and sell them in the market when you think the market value of those shares is high, and their value will decrease in the future when you will have to return them back in the future. (You pay interest upon the borrowed shares and also deal upon the uncertainty of their price in the future).

Agreements and contracts based on Gharar (uncertainty) can also be considered as gambling because as the buyer is not sure about the end result of his agreement (he may get less than what he paid for, equal, or more) and therefore due to this uncertainty, he / she will definitely pay below the market price.

Lesson 5

# SOURCES

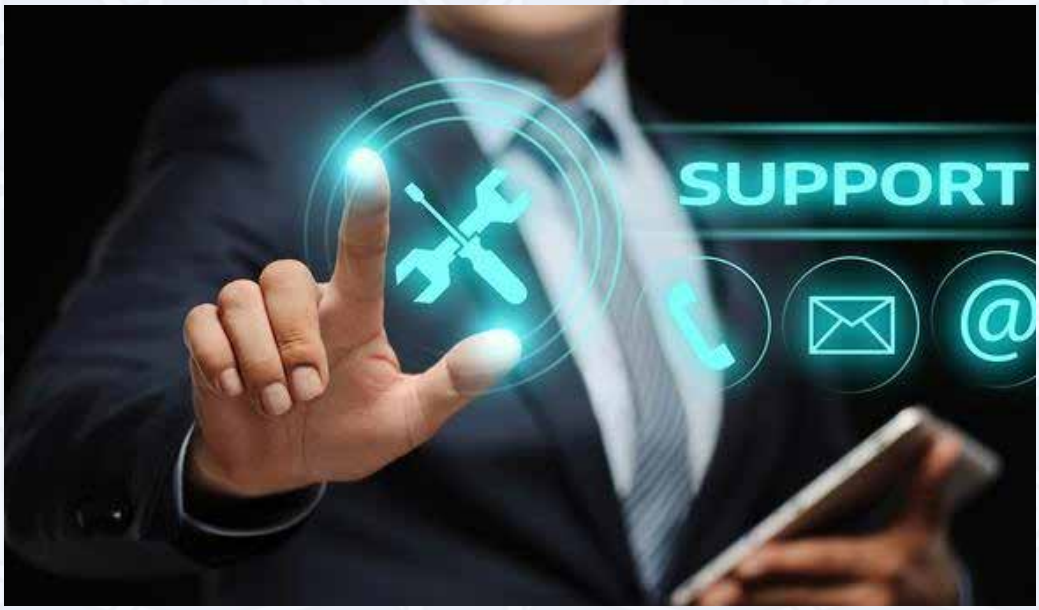
# 10 Communication of risks TO THE DEPOSITORS

Shariah has a contract called ‘Mudarabah contract’ – It is an agreement based on honesty and trust, wherein the 'Rabbul Maal' (fund owners and depositors) are offering the capital trusting the experience and ability of the Mudarib, and the ‘Mudarib’ (fund manager) manages and invests the capital.

All depositors who wish to avail the services of Islamic banks have to agree to this agreement, because it comprises of all the terms and conditions for the Mudarabah contract.

When the customer reads the Mudarabah agreement, he / she is explained all the terms and conditions item by item. They will know the bank's share of profit, or what the bank will do if someone wants to withdraw their deposit before maturity.

The obligations and the expectations from and to the system have to be clear because transparency is an obligation in Shariah, otherwise there are chances of Ghabn (deceit) causing the contract to be null and void.



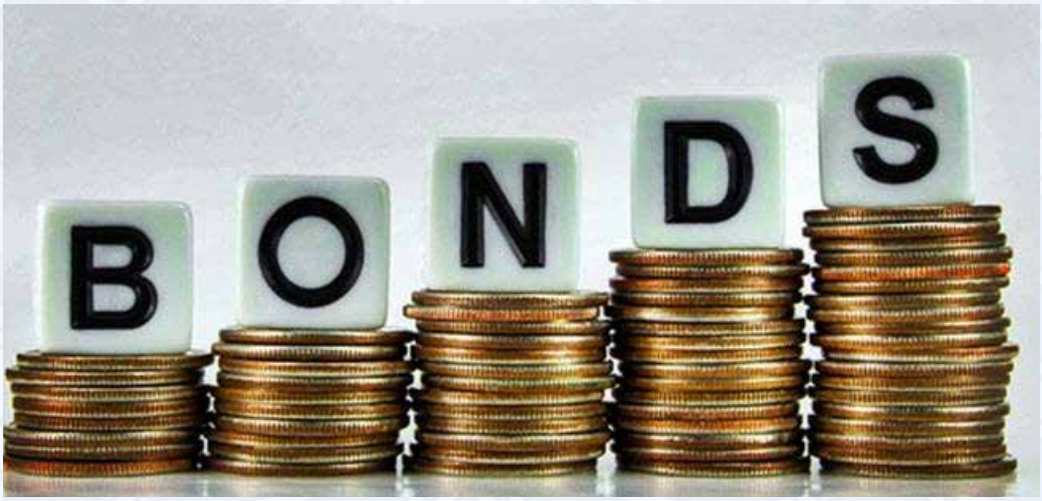
# 11 Shukook (ISLAMIC BONDS)

Other than funding from the current accounts and deposits based on Mudarabah, the banks can also issue Shukook (Islamic bonds).

While issuing Shukook bonds, the bank must prepare a note call to explain to the investors about the project, its cost, the expected returns based on the market feasibility study, percentage of profit sharing etc.

After the Rabbul Maal is explained about all the terms and conditions, they buy these certificates, and the bank finances the project from its proceeds under Mudarabah agreement or Musharakah agreement.

Upon completion of the project, the bank will receive its share as the Mudarib (manager) from the realised profit and the remaining profit will be distributed to the Shukook holders.



# 12 Application of funds BY AN ISLAMIC BANK

Conventional banks since their inception have only been dealing in loans with pre-agreed rate of interest because they are not allowed to trade or invest their deposits, nor are they allowed to buy and sell. The difference between the interest received by the bank from its customers and the interest paid to the depositors is the income of the bank. Different schemes like overdraft, facility, loan are all different names for the same product – loan with a pre-agreed rate of interest.

While Islamic banks, even though they are not permitted to deal in interest-based loans, they have unlimited products like Murabaha, Istisna, Salam, Musharakah, etc. And out of these nominated contracts and agreements, the banks can innovate hundreds of other products if they fall within the Shariah principles.

## FURTHER, WHEN ISLAMIC BANKING FIRST STARTED, FUNDS WERE INVESTED ACCORDING TO DIFFERENT SCENARIOS –

i. A separate pool of investment for shareholders equity and a separate pool of investment for the deposits

ii. A single investment pool combined of shareholders equity and the deposits

There may arise situations wherein the management may hold back low-risk profitable investment for the shareholders and invest the depositor's money in high-risk investments.

This discrimination is not permitted by the Shariah because the Mudarib is a Wakeel, and he must make sure to act in the interest of his Muwakkil equally and not discriminate between them.

Therefore, most of the Islamic banks have a single balance sheet with a common investment pool for all their customers.

Lesson 6

# APPLICATION FUND
# IN ISLAMIC BANK

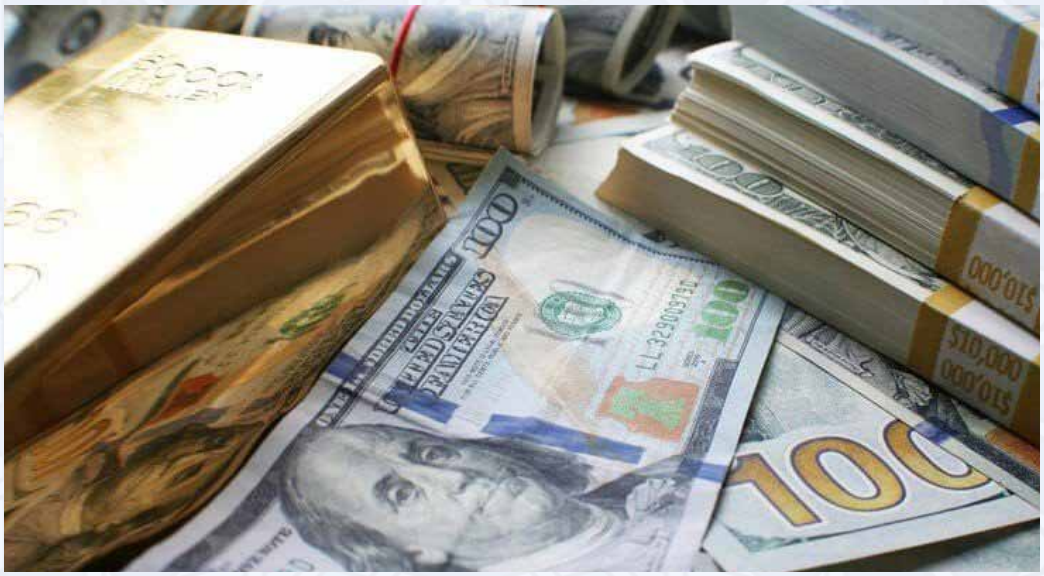
# 13 Communication of RISKS TO THE DEPOSITORS

Lease is a very simple product, if the customer is in need of an asset for his personal / business use but has no sufficient funds to buy,

## LEASE CAN BE OF TWO KINDS –

### i LEASE OUT ASSETS IN EXCHANGE OF MONEY

Customer hands over the titles of their leased / leasable assets to the bank in exchange for the finances needed by him to invest in his/her project. The banks benefits from the rentals until the customer is able to pay back the amount loaned to him by the bank, after which the bank sells / hands over the title deeds back to the customer.



## ii LEASE ASSET / EQUIPMENT FROM THE BANK WITH PROMISE TO BUY IT FROM THE BANK AT THE END OF THE LEASE PERIOD.

In this scenario, the customer needs an asset / equipment for his personal or professional use but does not have the finances to buy it. He / she approaches the bank to buy it for him and lease it to him for a fixed period, at the end of which he would buy off the asset / equipment from the bank.

They have two ways, either to pay the cost during the lease period as fixed elements, or if you don't have this money then you can pay it at the end of the lease period.

# QUESTION & ANSWER
BUCKET

# 01 WHAT ARE SOME OF THE BASIC CHARACTERISTICS OF THE ISLAMIC FINANCIAL SYSTEM?

Ans

**SOME OF THE BASIC CHARACTERISTICS OF THE ISLAMIC FINANCIAL SYSTEM ARE:**

i

## RISK SHARING AND NOT RISK SHIFTING

Compared to the conventional finance system, Islamic financing is based on the principle of risk sharing rather than risk shifting.

Risk sharing is when the loss will be borne by both the parties – the investor and the investee.

ii

## TYPE OF LIMITED LIABILITY PARTNERSHIP

The risk of loss will be shared by both the partners – the investor (responsibility is limited to the money they contribute) and the investee (responsible for the provision of their expertise, experience, knowledge, and labour).

## 02 EXPLAIN THE ROLE OF AN ISLAMIC BANK?

**Ans**

The idea of Islamic bank is like a joint stock company in which shareholders come together and decide to establish a bank. They agree and decide on the percentages for profit and loss sharing because the depositors are like shareholders – benefit from the profits according to their investments, but also bear the risk of loss with the bank.

Islamic banks raise funds from the little deposits of citizens and customers and pool them together in a single larger amount, and the same with shareholders equity. Using this pool of finances, the Islamic bank finances projects like factories, metros, etc., because individuals on their own cannot finance such projects alone.

## 03 WHAT WAS THE CAUSE FOR 2008 FINANCIAL CRISIS?

**Ans**

The demand of loans was very high due to low interest rates. Everyone wanted to borrow so that they could have their own house or their own business. Banks and financial institutions gave out loans with interest on large scales to people without taking care of their credibility or their ability to pay back.

According to the conventional interest-based system, when their borrowers could not pay back the loan installments, they are imposed with fines and an interest premium to be paid along with the installment for late payment. The more one delays in paying back the borrowed sum, the higher the fine and interest they must pay.

Let us assume that a loan of $1 million is given to a customer for purchasing a house, and after few months he is unable to continue to pay back his installments, due to which he is imposed with a fine and the interest calculation starts until he is able to start paying back his installments.

The important thing to realize is that though the amount that must be paid back to the bank by the borrower keeps increasing (even greater than the amount of the asset purchased, or security kept with the bank – eg: needs to pay back $10 million for his $1 million house and $1 million in security).

But the banks cannot continue with just the calculation of interests with recovering the loaned amount or the installments because the money loaned by the bank belongs to its depositors.

If the borrowers do not pay back their loans, the bank would end up bankrupt because it would not have finances to pay back the depositors when they would want their money.

It was due to such a situation that towards the end of the year 2009, around 8000 financial banks and institutions in United States alone become bankrupt.

The banks tried to liquidate the assets and sell off the houses to recover the loaned amount, but they failed because the supply was more than the demand (assets had to be priced lower than their market value), the amount to be recovered was much higher than the securities and the assets possessed by the banks. To buy off the assets put on sale by the bank, people needed loan, but the banks did not have the finances to give out new loans, and the cycle continues.

This was the cause of the 2008 financial crisis.

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