

DIPLOMA IN ISLAMIC BANKING AND FINANCE



DPD20042

ISLAMIC

FINANCIAL SYSTEM

Overview of
Islamic
Banking And
Financial
System

SITI NOORAIN AWALLUDIN



OVERVIEW OF ISLAMIC BANKING AND FINANCIAL SYSTEM

SITI NOORAIN AWALLUDIN

Sebuah Terbitan



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OVERVIEW OF ISLAMIC BANKING AND FINANCIAL SYSTEM

This module based on syllabus of DPD2023 Islamic Financial System Politeknik Malaysia.

JABATAN PERDAGANGAN

POLITEKNIK NILAI

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PREFACE

Thank to Allah SWT, the Most Gracious and Most Merciful. Bless be upon His Messenger Prophet SAW. I consider this e-book as my small and humble contribution to the readers and Muslim *ummah* as a whole. Truly, I was only able to complete this e-book by the Blessing of Allah SWT.

Therefore, I would like to express my thorough and gratefulness to Allah Almighty, who has given me the opportunity to write and complete this e-book relating to Islamic Financial System. I wish to extend my appreciation to friends and family for their encouragement and support, directly and indirectly especially to my mother, husband, and children.

Massive thanks to all my friends who have contributed many important points to the preparation of this e-book. They deserved this credit because they are the ones who have inspired me to write and publish this e-book. May Allah accept this humble effort, honor it with His pleasure, and make it beneficial for readers.

SITI NOORAIN AWALLUDIN
JABATAN PERDAGANGAN
POLITEKNIK NILAI



SYNOPSIS

This e-book coincides with the content of the syllabus for the DPD20042 Islamic Financial System course which is a compulsory course for Diploma in Finance and Islamic Banking, Politeknik Malaysia. It was produced to help students and lecturers in understanding topics related to Islamic banking in the early days of Islam, the development of Islamic banking in the modern era, the development of Islamic banking in certain Muslim countries, and the financial system in Malaysia. The advantage of this e-book is the simple and compact content which is accompanied by interesting graphics, pictures, and colors. This can attract the interest of readers not only students but of all ages as scholarly reading.





Content

<i>Preface</i>	i
<i>Synopsis</i>	ii
Definition of Islamic Banking	2
The Banking Practice in the Age of Prophet (SAW) and His Immediate Companions	5
The Banking Practice During the Time of Bani Umayyah and Bani Abbasiyah	8
The Development of Islamic Banking in the Modern Era	11
The Development of Islamic Banking in Certain Muslim Countries	15
Malaysia	16
Iran	20
Egypt	21
Pakistan	22
Jordan	23
Financial System in Malaysia	25

DEFINITION OF ISLAMIC BANKING

- DEFINITION
- OBJECTIVE
- THEORETICAL BASIS OF ISLAMIC BANKING

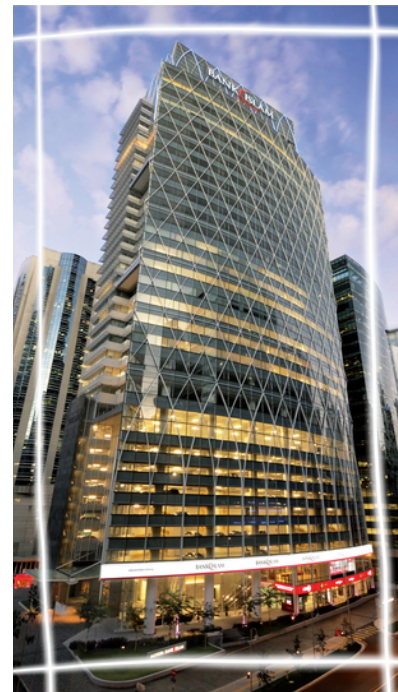


Definition of Islamic Banking

DEFINITION

Islamic banking is a banking or banking activity system based on Islamic law (Shariah). It must be inline with Shariah and *Fiqh muamalat* (Islamic Commercial transaction) that comes from the Quran and Sunnah and other valid sources of Islamic law such as *ijma'*, analogy (*qias*) and *ijtihad*.

Islamic Banking has offered various products in global market, both for Muslim and non-Muslim. It shows that Islam as a *Din* not just a religion but is a way of life that provides guidance regarding each aspect of life that also includes in economic. Islamic banking also has unique product and services that may attract consumer especially among non-Muslims.

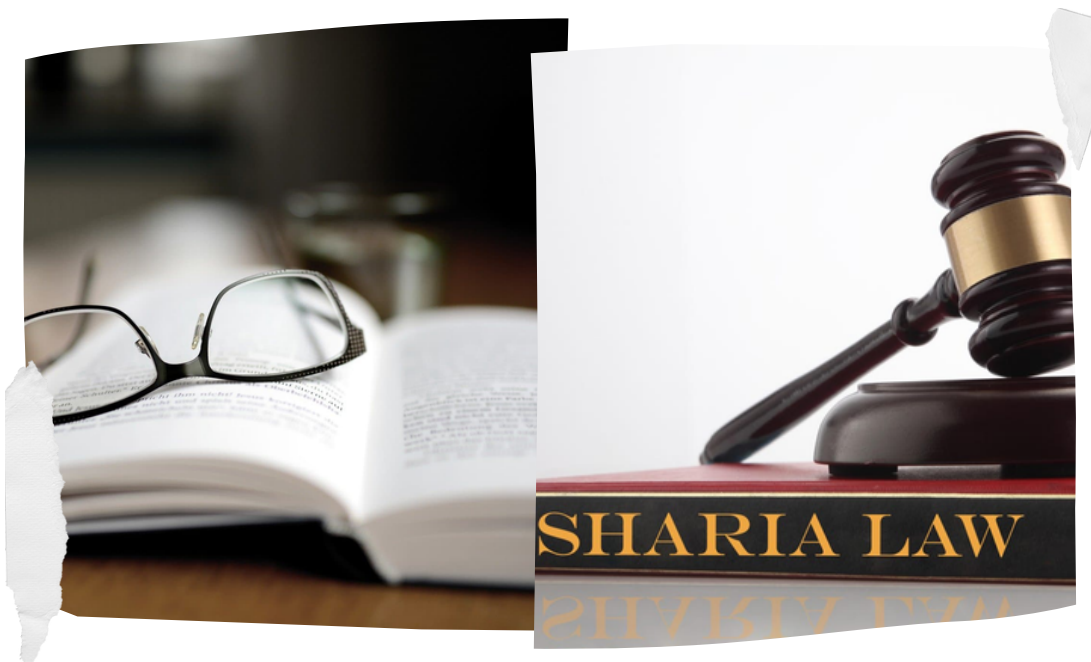


OBJECTIVE

To cater the needs of Muslim in banking transaction based on the concept of justice and fairness in the interest of society as a whole and the main sources is from Al-Quran and Hadiths.

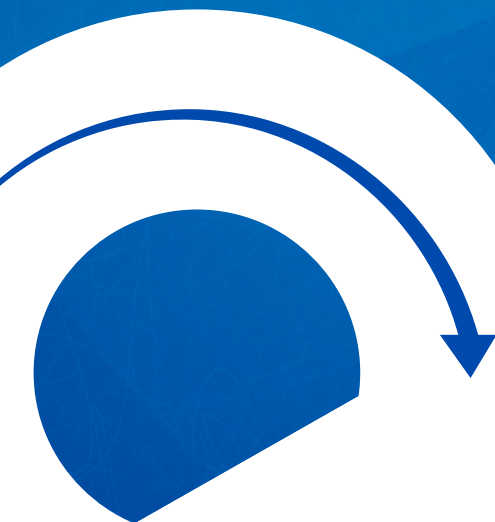
THEORETICAL BASIS OF ISLAMIC BANKING

Many products offered by the Islamic banks are similar to conventional banking, but some norms are exclusive to Islam. Before the introduction of Islamic Banking, all the Muslim customers rely on the conventional banking practices. Islamic banks products were near to the principles of Islam while the conventional banking products revolve around the earnings of interest (*Riba*) which is clearly prohibited in Islam.



The main basics principles of Islamic banking are derived from Al-Quran and Hadiths. Uncertainty (*Gharar*), interest (*riba*) and gambling (*maisir*) are strictly prohibited in Islamic modes of financing. In modern world Islamic banking the fatwas are taken from highly knowledgeable, credible and trustful ulama while offer a mode of financing. Muslim countries to establish and develop the financial institutions which were in accordance with the Islamic Laws and Shariah Principles.

THE BANKING PRACTICE IN THE AGE OF PROPHET (P.B.U.H) AND HIS IMMEDIATE COMPANIONS



The Banking Practice in the Age of Prophet (P.B.U.H) and His Immediate Companions

- 1 Before the coming of Islam, banking activities has begun in the Arab but its operation has the element of *riba*.
- 2 Prophet Muhammad before the time of his prophet hood had applied the concept of trust. Due to his noble conducts such as honesty and integrity, the Arabs of his had appointed him as their wealth keeper.
- 3 History noted how the Messenger of Allah, known as Al-Amin, was trusted by the people of Mecca to care for their estate, so at the last moment before the Hijra to Medina, he asked Ali to return the estate to all who possessed it.
- 4 The development of *Bayt al Mal*, which was the central bank for Islamic countries and played a role in aiding the poor, especially the Muslims.
- 5 A companion of the Prophet, Zubair Ibn Awwam, chose not to accept entrusted estate. He would prefer to accept it in the form of loans. First, by taking the money as a loan, he had the right to use it. Second, because its loan, he obligated to return it in full.
- 6 Other companion, Ibn Abbas was reported to perform money transfer to Kufah. Abdullah ibn Zubair in Mecca had some money delivered to his younger brother, Misab Ibn Zubair, who lived in Iraq.

The Banking Practice in the Age of Prophet (P.B.U.H) and His Immediate Companions

7 The use of checks (cheques) was also recognized in line with the growing trade between Palestine and Yemen, which lasted at least twice a year.

8 Even during the reign of Umar Ibn Khattab, he was using checks (cheques) to pay benefits to those who were entitled. With this check then they could exchange it with wheat at Baitul Maal which was imported from Egypt.

9 In addition, the provision of capital for profit-sharing based businesses, such as the *mudharabah*, *musyarakah*, *muzara'ah* *muzara'ah*, *musaqah*, have been known since long ago between the Muhajirun and the Ansar.

10 Furthermore, there is clear broad structure of principles practice by Prophet Muhammad (p.b.u.h) for example contract of *mudarabah* between Khadijah and Prophet (p.b.u.h), *musyarakah* whereby Al-Sa'ib Ibn Abi Al-Sa'ib became a partner of the Prophet (p.b.u.h.) before his prophethood, *bay' al-salam* was practiced in the agricultural sector of Madinah during the time of the Prophet (p.b.u.h.) and benevolent loans (*qard hasan*) which is another form of financing were also encouraged during that time.

THE BANKING PRACTICES DURING THE TIME OF BANI UMAYYAH AND BANI ABBASIYAH.



The Banking Practices During the Time of Bani Umayyah and Bani Abbasiyah.

1

At the time of the Prophet, the banking functions were performed by individuals, and usually only one person doing one function only. In the age of the Abbasids, the three banking functions were carried out by an individual in the history of Islam.

2

Banking began to develop rapidly when many types of currency were circulating in those days so that it required special skills to distinguish between the currencies. People with this special expertise were called *naqid*, *sarraf*, and *jihbiz*. The term has been known as *jihbiz* since the time of Muawiyah (661-680 AD) which is actually derived from Persian, Kahbad or Kihbud. During the reign of Sasanid, the term was used for a person who was assigned to collect the land tax.

The role of the bankers at the time of the Abbasid Caliphs began to become popular during the Muqtadir Administration (908-932M).

3

4

At the time, almost every vizier had its own bankers. For example Ibn Furat appointed Harun Ibn Imran and Yusuf Ibn Wahab as his bankers. Then Ibn Ali Isa appointed Ali ibn Isa, Hamid Ibn Wahab appointed Ibrahim ibn Yuhana, even Abdullah Al-Baridi had three bankers at the same time: two Jews and one Christian.

5

The advancement of the banking practices of that era was marked with the release of saq (check) as a medium of payment.

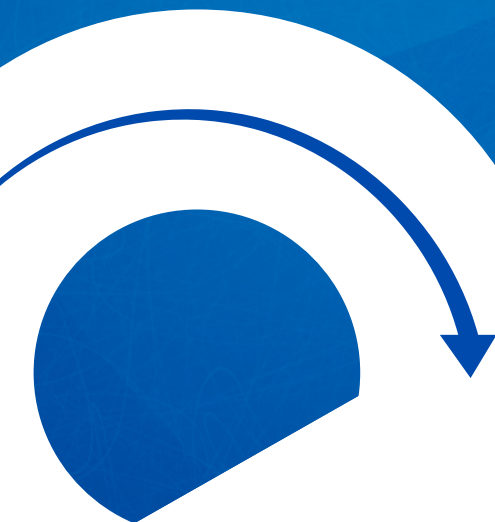
6

The role of the banker had even covered three aspects, i.e. accepting deposits, channeling, and transferring money. In the latter case, money could be transferred from one country to another without the need to physically transport it. Money changers who set up offices in many countries have begun to use checks as a medium of money transfers and other payment activities.

7

In the history of Sharia banking, Syaf Al-Dawlah Al-Hamdani is reported as the first person to issue a check for clearance between Baghdad (Iraq) and Aleppo (current day Spain).

THE DEVELOPMENT OF ISLAMIC BANKING IN THE MODERN ERA



The Development of Islamic Banking in the Modern Era

Mit Ghamr Local Saving Bank marks a new milestone in the revolution of the modern Islamic Banking System. This bank was considered to be the most innovative and successful experiment with interest-free banking.

Located in the Nile Delta, Egypt, the Mit Ghamr Local Saving Bank 1963 provided banking services such as deposits accounts, loan accounts, equity and participation, direct investment, and social services.

Although these services are considered basic banking services, it was nevertheless sufficient to meet the banking needs of the surrounding community. Besides the ability to prevent customers from going to money lenders for financial assistance, this bank was able to instill a sense of belonging among its customers. These were the contributing factors to its success.



One of the most important contributions made by this bank to Islamic banking history was that it proved to the Muslim community that there was an alternative to the conventional banking system.

However, the turbulent political situation adversely affected the bank. Its operations were consequently undertaken by the National bank of Egypt and the Central Bank in the second half of 1967. The interest-free concept was abandoned and Mit Ghamr's operations, reverted to an interest-based system.

In 1971, under the regime of **Mr. Anwar Sadat**, the interest-free concept was revived and the new institution by the name of Nasser Social Bank was established to carry out businesses based on shariah concepts. Though the bank is still active, its objectives are more social than commercial.



The late **King Faisal bin Abdul Aziz Al-Saud** of Saudi Arabia, was one of the noteworthy individuals who had made a major contribution to Islamic Economics by initiating the establishment of the Organization of Islamic Conference (OIC).



Under his majesty's leadership and initiative, Muslim countries were urged to establish Islamic Financial and Economic institutions which were free from *riba* (interest).

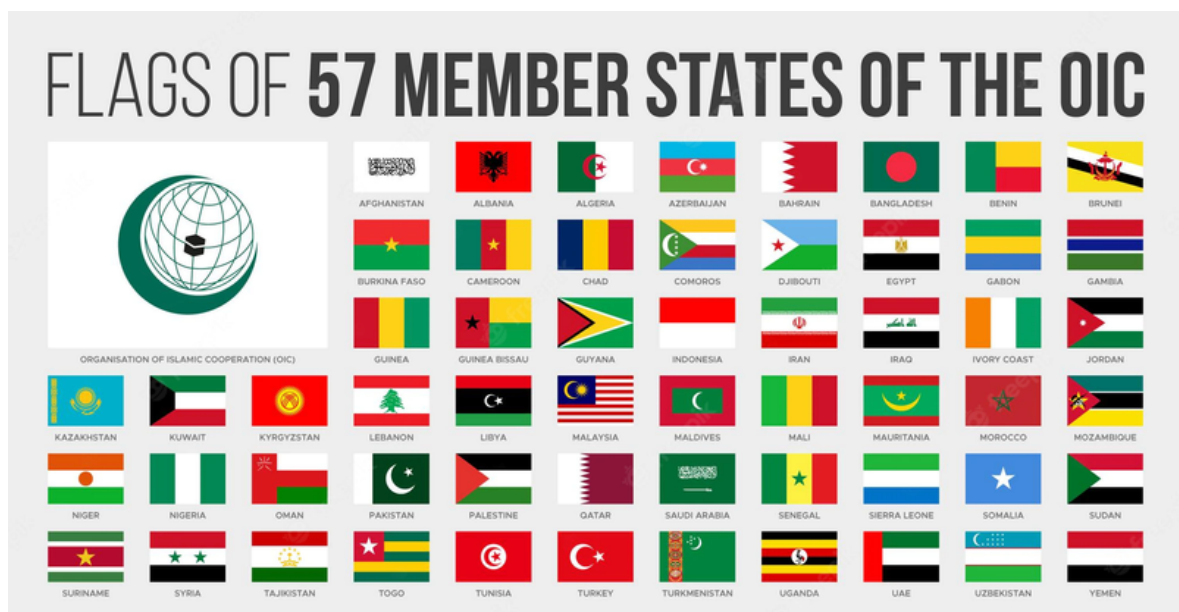


The second conference of OIC Foreign Ministers which was held in Karachi, Pakistan in December 1970, passed a resolution that a study is made on the establishment of an International Islamic Bank for Trade and Development together with a Federation of Islamic Banks.

The task of preparing the proposal of these institutions was given to experts from 18 Islamic countries. In presenting their report, the experts recommended the establishment of three institutions:

1. The international Islamic bank
 - function similar to the normal commercial bank
2. Investment and development body of Islamic country
 - function as an investment institution
3. Association of Islamic Banks
 - serve as a body in the field of Islamic economy and banking, reverted to an interest-based system.

The second meeting in Bengzi, Libya in March 1973, the Minister examined the proposal of the establishment of the various institutions as suggested in the earlier and it was decided that a financial and economic department should be set up within the Islamic Secretariat.



In July 1973 a committee of experts from the oil-producing Islamic countries met in Jeddah and discussed the establishment of an Islamic bank. Their subsequent meeting was held in May 1974 where the bank's charter, its rules and regulations were drafted.

This drafted was approved in August 1974 by the Finance Minister of OIC. The Islamic Development Bank (IDB) was officially established in October 1975 with a founding member of 22 Islamic countries. The bank principal office was located in Jeddah, Saudi Arabia and has two regional offices in Rabat, Morocco and in Kuala Lumpur, Malaysia.

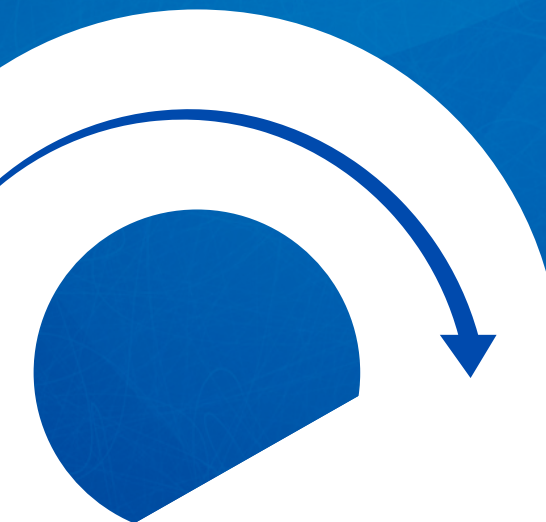


1975, Dubai Islamic bank was incorporated and in the year 1977, three more Islamic Banks commenced businesses i.e. FAISAL Islamic Bank of Egypt, Faisal Islamic Bank of Sudan, and Kuwait Finance House.



THE DEVELOPMENT OF ISLAMIC BANKING IN CERTAIN MUSLIM COUNTRIES

- MALAYSIA
- IRAN
- EGYPT
- PAKISTAN
- JORDAN



The Development of Islamic Banking in Certain Muslim Countries

MALAYSIA

The 1950's in Malaysia when a group prominent educators led by Royal Professor Ungku Aziz sought government backing and approval from local religious leaders to establish a unique saving institution, Lembaga Tabung Haji.



Hence in September 1963 the Perbadanan Wang Simpanan Bakal-bakal Haji (PWSBH) was set up as an institution for Muslims to save for their Haj (pilgrimage to Mecca) expenses. In 1969, PWSBH merged with Pejabat Urusan Tabung Haji to form Lembaga Urusan dan Tabung Haji (now known as Lembaga Tabung Haji).

The move towards establishing an Islamic bank in Malaysia was initiated by private parties. The first formal request was made during the Bumiputera Economic Congress in 1980. The congress passed a resolution which required the government to allow the Pilgrimage Board to establish an Islamic bank.

Nation seminar on The Concept of Development in Islam held in 1981 at Universiti Kebangsaan Malaysia (UKM), the participant requested the government to promulgate special law which allows the setting up of a new bank based on Islamic principles.



In the line with these requests, the government, on July 30, 1981, appointed a National Steering Committee to study both the operations of the Faisal Islamic Bank of Egypt and the Faisal Islamic Bank of Sudan.

Below are among the recommendations made by the committee in its report which was presented to the Prime Minister of Malaysia on July 5, 1982:

- 1** Operations are in accordance with the principles of Shariah.
- 2** Bank is incorporated under Companies Act, 1965.
- 3** A new Islamic banking act must be introduced to license and supervise (the responsibility of the Central Bank of Malaysia) the Islamic bank.
- 4** Islamic bank has to establish its own Shariah Supervisory Board to ensure their operation accordance with the Shariah.



The first Islamic Bank, Bank Islam Malaysia Berhad (BIMB) was incorporated on March 1, 1983 and commenced operation on July 1, 1983. The bank now has a network of more than 100 branches.



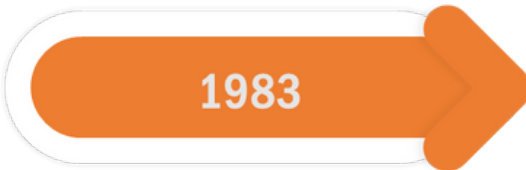
The Development of Islamic Banking in Certain Muslim Countries

IRAN



1984

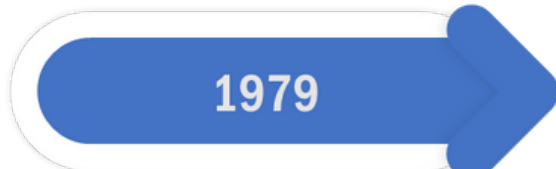
in 1984, interest free banks started to implement Islamic banking based on the 1983 law.



1983

In 1983 the Islamic Banking law of Iran was passed by the Islamic Majlis of Iran.

According to this law, Iranian banks can only engage in interest-free Islamic transactions because interest is considered as usury and is forbidden by Islam and the holy book of Qur'an.



1979

The government of Iran played a primary role in converting conventional banking into Islamic banking after 1979 revolution.

The Development of Islamic Banking in Certain Muslim Countries

EGYPT

MIT GHAMR LOCAL SAVINGS BANK (1963)

Located in the Nile Delta, Egypt, the Mit Ghamr Local Saving Bank 1963 provided banking services such as deposits accounts, loan accounts, equity and participation, direct investment and social services.



1963

CENTRAL BANK (reverted)

due to changes in the political climate of Egypt – been undertaken by the National Bank of Egypt & the Central Bank – reverted back -reduced the no. of depositors drastically.



1967

NASSER SOCIAL BANK (1971)

operates autonomously under the Ministry of Social Affairs and Insurance as an interest-free commercial bank although it does not bear any specific reference to Islam.



1971

FAISAL ISLAMIC BANK (1977)

The Bank was incorporated under Law no. 48 of 1977 which was then endorsed by the Egyption Parliament and the Bank was licensed as an economic and social institution taking the form of an Egyptian Joint-Stock Company operating in compliance with Islamic Sharia principles.



1977

INTERNATIONAL BANK FOR INV. & DEV. (1980)

Provides Islamic commercial banking services including deposits and loans.



1980

The Development of Islamic Banking in Certain Muslim Countries

PAKISTAN

Islamic Provisions of 1973 Constitution among others include... " the state shall eliminate *riba* as early as possible" ...

1973

In 1980's banks were prohibited to accept any interest-bearing deposits and new terminology of Profit and Loss Sharing (PLS) was introduced

1980

From 1985, no banks were allowed to accept any interest-bearing deposits and all existing deposits became subject to PLS (Profit and Loss Sharing) rules

1985

2001

In September 2001 it was decided by government to shift to the interest free economy would be made in a gradual and phased manner and without causing any disruptions.

For this purpose, SBP was given the task to start Islamic banking in Pakistan

2002

Al Meezan Investment Bank received the **first Islamic commercial banking license** from SBP in January 2002 and the **Meezan Bank Limited (MBL)** commenced full-fledged commercial banking operation from March 20, 2002.

2004

In 2004, State Bank of Pakistan permitted conventional commercial banks to establish Shariah-compliant non-banking finance companies (NBFC's).

Islamic financial institutions in Pakistan include Meezan Bank, Habib Bank, Muslim Commercial Bank, Bank Al Falah and AG Zurich

The Development of Islamic Banking in Certain Muslim Countries

JORDAN



1978

Jordan Islamic Bank

(Oldest and largest Islamic bank in Jordan, the bank was established in 1978).



Islamic International Arab Bank

(Second largest Islamic bank in Jordan, the bank was established in 1997)

1997



2010

Safwa Islamic Bank

(Third largest Islamic bank in Jordan, commenced its business in 2010).

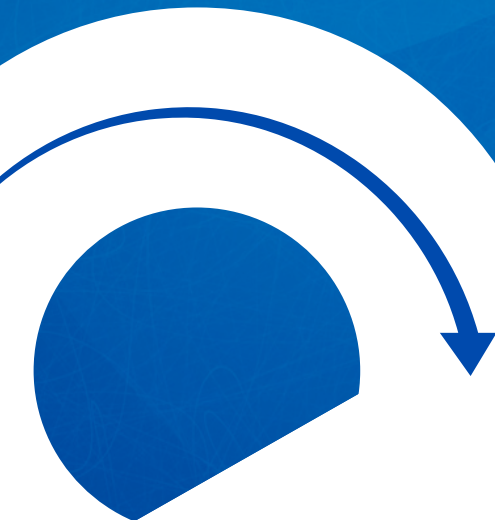
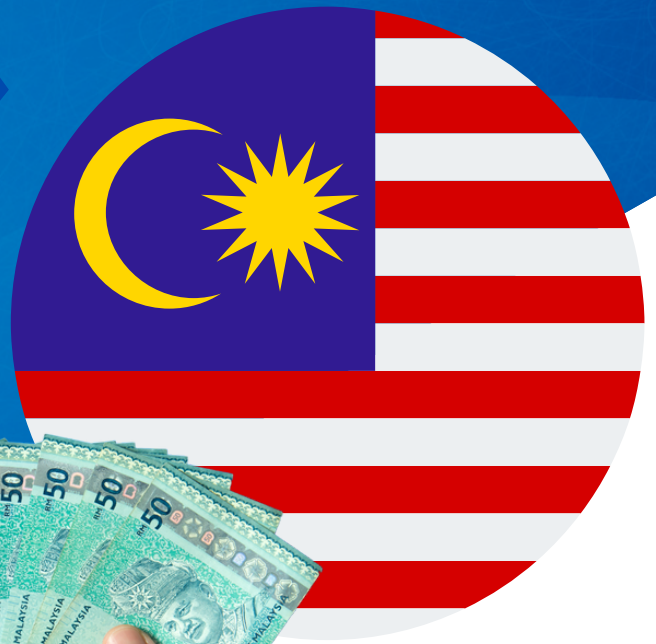
Al Rajhi Bank

(Foreign Branch).
Islamic Finance In
Jordan 7/9/2018

2018



FINANCIAL SYSTEM IN MALAYSIA



Financial System in Malaysia

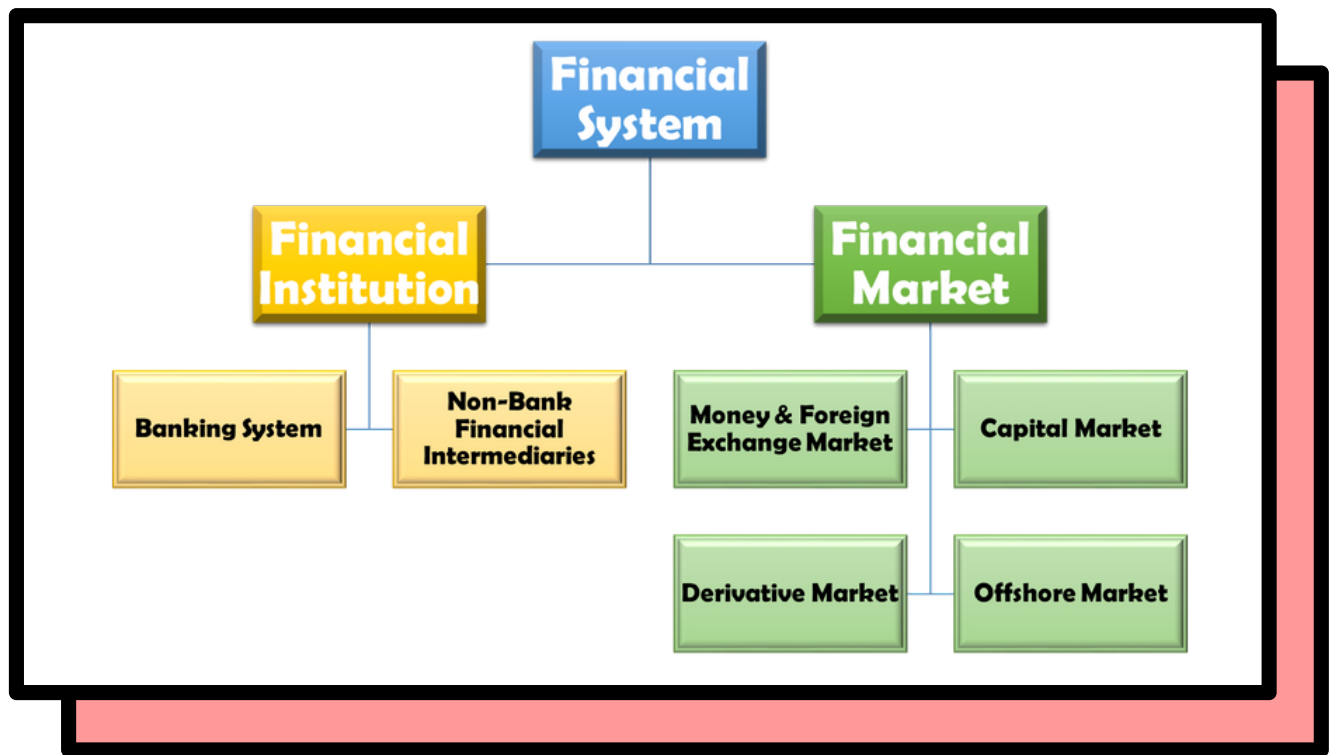


Chart 1 : Financial System in Malaysia

The financial system act as a mechanism that transfers fund from the party with excess fund to the party that needs the fund. In general, a financial system facilitates financial transactions that generate economic growth. Malaysia's financial system structure is divided into three parts, i.e. banking system, non-bank financial intermediary system and financial markets.

The structure of the Malaysia financial system is presented in Chart 1. During the 1990's, the financial system was broadened with the introduction of the Labuan International Offshore Financial Centre (IFOC) in 1990, an integrated offshore center that provided a wide range of offshore products in addition, the period also saw the introduction of the financial derivatives markets in 1995. in terms of structurer, the institutions can broadly be divided into the banking system and the non-bank financial intermediaries.

Financial Institution



Banking

01

1. Bank Negara
2. Banking Institution
 - a. Commercial Banks
 - b. Finance Company
 - c. Investment Banks
 - d. Islamic Banks
3. Others
 - a. Discount House
 - b. Representative Office of Foreign Banks
 - c. Labuan Off-Shore Banks



Non-bank Financial Intermediaries

02

1. Provident and Pension Funds
2. Insurance Companies (Including Takaful)
3. Development Finance Institutions
4. Saving Institutions
5. Others
 - a. Unit Trusts
 - b. Pilgrims Fund Board
 - c. Housing Credit Institutions
 - d. Cagamas Berhad
 - e. Credit Guarantee Corporation
 - f. Leasing Companies
 - g. Factoring Companies
 - h. Venture Capital Companies

Financial Market



Money & Foreign Exchange Market

1. Money Market
2. Foreign Exchange Market

01



Capital Market

1. Equity Market
2. Bond / Sukuk Market
 - a. Public Debt Securities
 - b. Private Debt Securities

02



Derivatives Market

1. Commodity Futures
2. KLSE CI Futures
3. KLIBOR Futures

03



Offshore Market

1. Labuan International Offshore Financial Center (IOFC)

04

Overview of Islamic Banking And Financial System

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