

Diploma in Islamic Banking (DIB), Part-I

Exam:
Nov'24

Code: 101 (Alternative Financial System)

Session-I

Chapter:
1, 2 & 5

**(Introduction to the Alternative Financial System
Development of an Alternative Financial System
& Alternative Money Market)**

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Organizer

**Islami Bank Training & Research
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Session overview

The following important topics will be covered from [chapter 1](#) (Introduction to the Alternative Financial System), [chapter 2](#) (Development of an Alternative Financial System) and [chapter 5](#) : (Alternative Money Market) of code-101 of DIB Part-I syllabus:

1. [Alternative Financial System](#)
2. Historical Overview of Islamic Finance
3. [Features and Fundamental principles of Alternative Financial System](#)
4. International Infrastructure Institutions (AAOIFI, IFSB, CIBAFI, IIFM)
5. Position of Islamic finance in Bangladesh
6. [Factors of increasing popularity of the AFS](#)
7. Alternative money market, capital market, money market tools

1. Alternative Financial System

Alternative Financial System (AFS) refers to accomplishing the financial needs of the people in an alternate way or in different ways which can fill the **vacuum** left by traditional institutions. It includes, offering greater variety, more flexibility and easier access to the financial networks etc. AFS serves populations that **don't have access to financial system**, such as the **poor** people, **less privileged** groups and those who have **no credit history** and more.

Islamic Financial system is considered as Alternative Financial System (AFS) because it meets the financial need of the people in a Shari`ah compliant manner.

In different jurisdictions, alternative finance is called by different names, such as “**Shari`ah-compliant finance/banking**”, “**non-interest banking**”, “**participation banking/finance**” etc.

2. Historical Overview of Islamic Finance

- The origin of Islamic banking can be traced back to the **practice of *mudaraba*** at the time of **Prophet Muhammad** (Sm) .

“Abbas Ibn Abdul Muttalib used to pay money for Mudaraba and stipulate to the Mudarib that he should not travel by sea, pass by valleys or trade in livestock, and that the Mudarib would be liable for any losses if he did so.” (Bayhaqi 6:111)

These conditions were brought before the Prophet (Peace be Upon Him) and he approved them.

- **Umar bin Khattab (RA)** gave a man the funds belonging to an orphan for the purpose of Mudaraba and the man was trading with these funds in Iraq.

Al-Bayhaqi in Al Ma'rifah (see Al-Zayla'i, "Nasb Al-Rayah")

- The **first attempt** to establish an Islamic financial institution took place in **Pakistan in late 1950s** with the establishment of a local Islamic bank in a rural area. Borrowers of the bank **did not pay interest** on the credit advanced, but a **small charge** was levied to cover the bank's operational expenses. (Ref. https://en.banglapedia.org/index.php/Islami_Banking)

2. Historical Overview of Islamic Finance (Contd.)

- The **second experiment** with Islamic banking was conducted in **Egypt in 1963** through the establishment of the **Mit Ghamr Savings Bank** in a rural area of the Nile Delta by Ahmad El Najjar. On the basis of success in the experiment more branches were soon opened in different parts of Egypt. The project **suffered a setback** due to political unrests in the country but was **revived** in 1971 under the name of **Nasser Social Bank**, which became the first Islamic bank in the urban areas in Cairo. (Ref. https://en.banglapedia.org/index.php/Islami_Banking)
- The **first bank explicitly based on Shari'ah principles** was established by the Organization of Islamic countries (OIC) in 1974, called **Islamic Development Bank (IsDB)**. This bank was primarily engaged in **intergovernmental** activities for providing funds for development projects running into member countries. Its business model involved **fees** for financial services and **profit sharing** financial assistance for projects. (<https://www.lawyersnjurists.com/article/explain-islami-system-of-banking-and-the-privileges-it-offers/>)
- With time, during the 1970s **several Islamic banks** came into existence, including the **Dubai Islamic Bank** (first Islamic private commercial bank, 1975), the **Faisal Islamic Bank of Sudan** (1977) and the **Bahrain Islamic Bank** (1979).

2. Historical Overview of Islamic Finance (Contd.)

- By the end of 1976 there were 9 such banks in different countries. These banks neither charged nor paid interest but their activities were mostly limited to trade and industries where these banks invested directly or as partners of depositors.
- Islamic banking started in Bangladesh through establishment of the **Islami Bank Bangladesh Limited** (Now Islami Bank Bangladesh PLC), which is considered to be the first interest-free bank in Southeast Asia. It was **incorporated on 13 March 1983** as a public limited company under the companies act 1913.



3. Features and Fundamental principles of Alternative Financial System

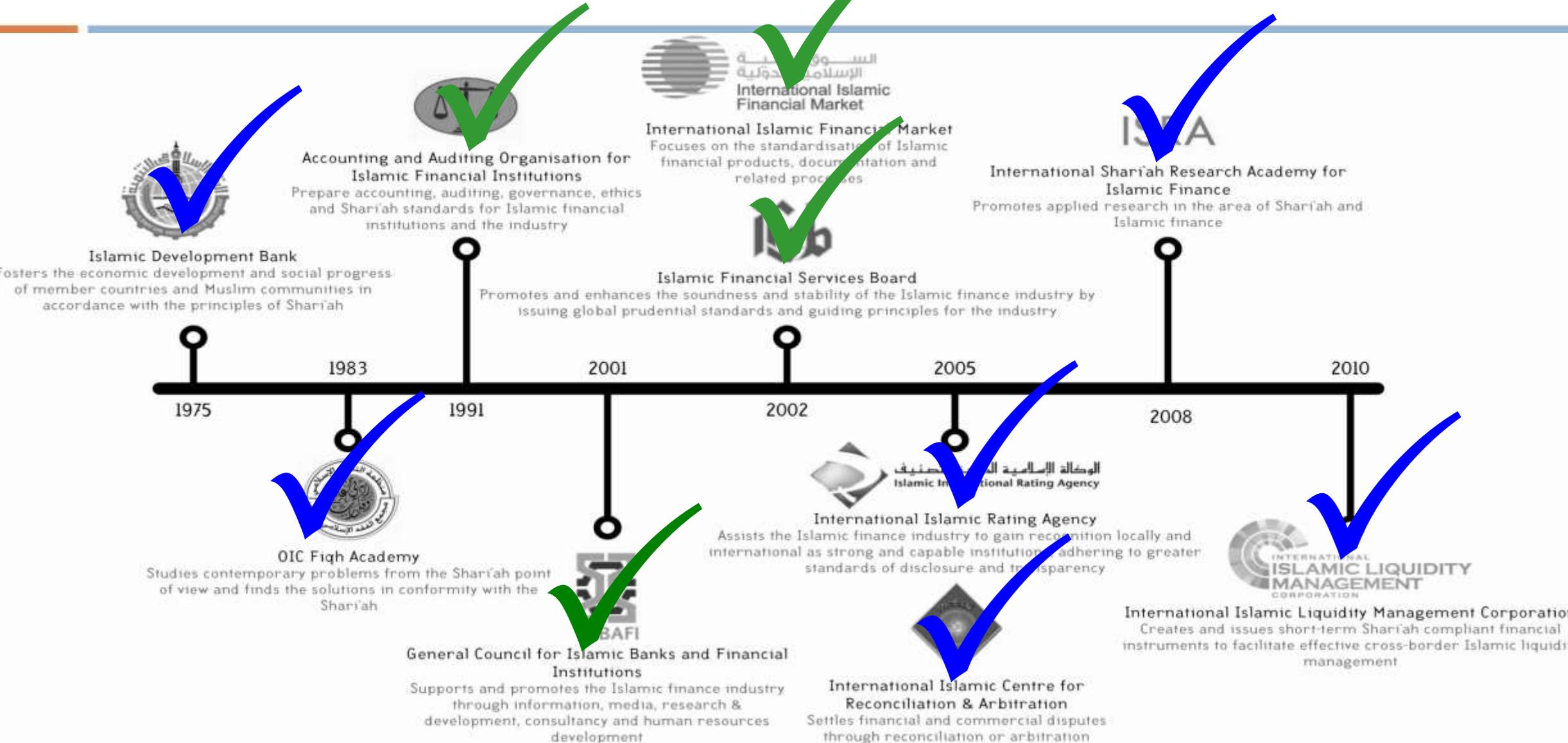
Shari'ah is the foundation of the Alternative Financial System, emphasizing equity, fairness, and ethical practices. Its key principles include:

1. **Prohibition of Riba (Interest):** Charging interest is forbidden, as it leads to exploitative gains without risk or economic contribution.
2. **Prohibition of Gharar (Uncertainty):** Contracts with excessive ambiguity are disallowed, ensuring transparency and fairness in transactions.
3. **Prohibition of Maisir (Speculation):** Speculative, gambling-like transactions are not permitted, encouraging responsible risk-taking.
4. **Prohibition of Dharar (Harm):** Any form of harm or injustice in financial contracts is prohibited. Exploitation or injury to others through banking activities must be avoided.

3. Features and Fundamental principles of Alternative Financial System (contd.)

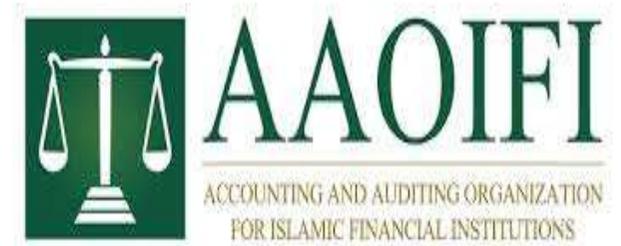
5. **Risk Sharing:** Islamic finance promotes shared risk, unlike conventional systems where the borrower bears the burden.
6. **Profit and Loss Sharing:** Contracts like Mudarabah and Musharakah ensure both parties share risks and rewards.
7. **Asset-Backed Financing:** All transactions must involve tangible assets, avoiding speculation and promoting real economic activity.
8. **Ethical Investment:** Investments in haram (forbidden) industries like alcohol, gambling, and weapons are prohibited, aligning finance with Islamic ethics.
9. **Wealth Distribution:** Zakat ensures wealth is circulated to support societal welfare and poverty alleviation.
10. **Social Justice and Ethical Conduct:** The system promotes fairness and justice, benefiting individuals and society while aligning with Islamic values.

4. International Infrastructure Institutions for IFIs



4.1 AAOIFI

- Leading international not-for-profit organization primarily responsible for development and issuance of standards for the global Islamic finance industry.
- Established in 1991
- Head Quarter: Manama, Bahrain
- The **objectives** of AAOIFI include:
 - Develop the **accounting and auditing concepts** relevant to IFIs;
 - Disseminate the accounting and auditing concepts relevant to IFIs and their application through **trainings, seminars, publications, research** and other means;
 - Prepare, promulgate and interpret accounting and auditing **standards** for IFIs;



4.1 AAOIFI (Contd.)

AAOIFI key facts and figures



1991

Founding year

Not-for-profit standard-setting organization based in the Kingdom of Bahrain



160+

Member institutions*

In 37 countries which includes 17% central banks, regulatory authorities, and other Islamic financial institutions



5

Areas of standard development

Standards and technical pronouncements in issue (Shari'ah - 59, Accounting - 31, Governance, Auditing & Ethics - 24)



117

Standards and technical pronouncements in issue

By a team of 50+ Shari'ah Scholars & 60+ professionals (besides 100+ working group members) representing 20+ countries



3

Technical boards

- AAOIFI Shariah Board (20 members)
- AAOIFI Accounting Board (15 members)
- AAOIFI Governance & Ethics Board (15 members)



35+

Countries / regulatory jurisdictions Footprint

Where AAOIFI standards are either adopted in full or partial or where it is used as guidelines

4.1 AAOIFI (Contd.)

Issued **117** standards and technical pronouncement in the areas of Shari'ah, accounting, auditing, governance and ethics.

SI	Areas	No. of Standards (As per AAOIFI Website)
1.	Shari'ah	61*
2.	Accounting	33**
3	Auditing	6
4.	Ethics	3
5.	Governance	14
Total		117

* Including 2 newly issued standards.

** Now **43** with newly issued 10 standards.

Ref. <https://aaoifi.com>

4.1 AAOIFI (Contd.)

Role of AAOIFI in Islamic Finance:

- ❖ **Developing Shari'ah Standards:** Issues standards covering contracts, products, and services to ensure compliance with Islamic principles.
- ❖ **Promoting Uniformity:** Provides global consistency in Shari'ah interpretations, reducing regional differences and facilitating cross-border transactions.
- ❖ **Enhancing Financial Reporting Transparency:** Sets accounting standards aligned with Shari'ah for clear and ethical financial reporting.
- ❖ **Auditing and Governance:** Provides guidelines for Shari'ah audits and establishes Shari'ah Supervisory Boards (SSBs) for oversight.
- ❖ **Supporting Regulators:** Works with governments and regulators to implement its standards, ensuring broad adoption worldwide.

Role of AAOIFI Shari'ah standards to ensure Shari`ah compliance in IFIs

AAOIFI Shari'ah standards play a pivotal role in ensuring Shari'ah compliance across Islamic financial institutions globally by:

- ❖ **Standardizing Practices:** They provide uniform guidelines for Islamic financial products, ensuring consistency in Shari'ah-compliant operations worldwide.
- ❖ **Global Applicability:** Adopted in over 45 countries, the standards ensure consistency and credibility across diverse markets.
- ❖ **Product Development:** The standards guide institutions in structuring Shari'ah-compliant products like murabaha, ijarah, sukuk, and takaful.
- ❖ **Regulatory Integration:** Many central banks incorporate AAOIFI standards into their frameworks, harmonizing Shari'ah compliance with national regulations.
- ❖ **Governance and Auditing:** AAOIFI standards require effective governance and auditing mechanisms to monitor Shari'ah compliance within institutions.
- ❖ **Transparency:** They mandate transparent reporting and disclosure of Shari'ah compliance, ensuring accountability in Islamic financial institutions worldwide.

4.2 CIBAFI



- CIBAFI is an international **non-profit** organisation founded in **2001** in **Bahrain** by the Islamic Development Bank (**IsDB**) and a number of leading Islamic financial institutions. CIBAFI is affiliated with the Organisation of Islamic Cooperation (OIC).
- With over **130 members** from more than **30 jurisdictions** all around the world, CIBAFI is recognised as a key piece in the international architecture of Islamic finance.
- In its mission to **support the Islamic** financial services industry growth by providing specific activities and initiatives that leverage current opportunities while preserving the value proposition of Islamic finance, CIBAFI is guided by its **Strategic Objectives**, which are,
 - 1) **Advocacy** of Islamic Finance Values and Related Policies & Regulations;
 - 2) **Sustainability** and **Innovation** Integration;
 - 3) Industry **Research** and **Analysis**; and
 - 4) **Professional Development**.

4.3 IIFM

IIFM is a global standard-setting body of the Islamic Financial Services Industry (IFSI) focusing on **standardization of Shari'ah-compliant financial contracts** and **product confirmations**.

IIFM which is based in Manama and hosted by the Central Bank of **Bahrain** (CBB), was established in **2002**.

Its mission is to create a robust, transparent and efficient Islamic financial market, IIFM promotes at the global level **unification, best practices** and Shari'ah harmonization through introducing and developing Shari'ah compliant standard financial contracts. IIFM published total **16 standards** on different products of Islamic finance.



4.4 IFSB

Islamic Financial Services Board is an international standard-setting organization which started operations in **2003**.

- **Headquarter:** Kuala Lumpur, Malaysia
- **Chairman** : H.E. Ayman Alsayari Governor Saudi Central Bank.
- **Secretary General:** Dr. Bello Lawal Danbatta
- As at December 2022, the **187** members of the IFSB comprise **80** regulatory and supervisory authorities, **10** international inter-governmental organisations, and **97** market players (financial institutions, professional firms, industry associations and stock exchanges) operating in **57** jurisdictions.
- Since its inception, the IFSB has issued **36 Standards**, Guiding Principles and Technical Notes for the Islamic financial services industry.

4.4 IFSB

Role of IFSB in the development of Islamic banking and finance.

The Islamic Financial Services Board (IFSB) plays a pivotal role in shaping the landscape of Islamic banking and finance by providing essential guidance, standards, and regulatory frameworks. As a global standard-setting organization, the IFSB promotes the stability and soundness of the Islamic financial industry. It facilitates the growth of Islamic banking and finance by developing internationally recognized prudential standards, guiding principles, and best practices that align with Shariah principles. These standards cover various aspects of the industry, including **risk management, capital adequacy, corporate governance, and disclosure requirements**. By fostering a harmonized regulatory environment and fostering collaboration among stakeholders, the IFSB contributes significantly to the development, stability, and sustainability of Islamic banking and finance on an international scale.

5. Difference between Alternative Financial System (AFS) and the Conventional Financial System (CFS)

Aspect	Alternative Financial System (IFS)	Conventional Financial System (CFS)
Basis of Operation	Operates on Islamic Shariah principles	Operates on interest-based transactions
Interest (Riba)	Prohibits payment or receipt of interest	Relies on interest-based transactions
Speculation and Uncertainty	Prohibits excessive uncertainty and speculation	May involve speculative practices and uncertainty
Risk and Reward Sharing	Emphasizes risk and reward sharing	Risk is primarily borne by the borrower
Asset-Backed Financing	Requires transactions to be backed by tangible assets	May involve loans not necessarily tied to specific assets
Social Responsibility	Encourages ethical investing and social responsibility	Primarily focuses on profit without strict ethical considerations

6. Position of Islamic finance in Bangladesh (Mar'2024)

No. of Islamic Financial Institutions (IFIs)

Srl	Nature of IFI	No. of IFI	No. of Br/Window
01.	Full Fledged Islamic Bank	10	1672
02.	Conventional Bank with Islamic Banking Branch	15	31
03.	Conventional Bank with Islamic Banking Windows	16	646
04.	Full Fledged Islamic Non-Bank Financial Institutions (NBFIs)	03	Not Sure
05.	NBFIs with Islamic Banking Windows	04	Do
06.	Islamic Insurance Company	11	Do

Ref. Quarterly Report on Islamic Banking in Bangladesh, Bangladesh Bank.

[https://www.bb.org.bd/pub/quaterly/islamic_banking/ibq3_mar_2024%20_28.5.24%20\(final\).pdf](https://www.bb.org.bd/pub/quaterly/islamic_banking/ibq3_mar_2024%20_28.5.24%20(final).pdf)

and Banking Review Series-2024, Islamic Banking Operations in Bangladesh, BIBM, <https://www.bibm.org.bd/publications-read.php?id=113>

6. Position of Islamic finance in Bangladesh (Mar'2024)

Market Share of Islamic Banks (IBs)

Srl	Item	Market Share	
		Dec'2023	Mar'2024
01.	Deposits	25.35%	26.23%
02.	Investment	28.92%	28.24%
03.	Remittances	37.27%	37.52%
04.	Number of bank branches	15.07%	15.09%

Ref. Quarterly Report on Islamic Banking in Bangladesh, BB,
[https://www.bb.org.bd/pub/quarterly/islamic_banking/ibq3_mar_2024%20_28.5.24%20\(final\).pdf](https://www.bb.org.bd/pub/quarterly/islamic_banking/ibq3_mar_2024%20_28.5.24%20(final).pdf)

7. Factors of increasing popularity of the AFS

1. **Ethical and Moral Principles:** The prohibition of interest (riba) aligns with ethical and moral principles in various cultures, attracting individuals who seek financial systems that avoid interest-based transactions.
2. **Asset-Backed Financing:** Islamic finance requires transactions to be backed by tangible assets or services, providing a more secure and transparent framework that appeals to those who prefer asset-backed financing.
3. **Avoidance of Unethical Investments:** Islamic finance avoids investments in sectors deemed unethical, such as gambling, alcohol, and pork-related industries. This aligns with the values of socially conscious investors.
4. **Demographic Influence:** Growing Muslim Population
5. **Financial Inclusion:** Targeting those with religious or cultural preferences for Shariah-compliant financial products.

7. Factors of increasing popularity of the AFS (Contd.)

6. **Government Support:** Some governments have actively supported the development of Islamic finance by establishing regulatory frameworks, encouraging the establishment of Islamic banks.
7. **Globalization and Financial Integration:** Expanded beyond traditional Islamic regions, gaining acceptance and popularity in non-Muslim-majority countries.
8. **Innovation in Financial Products:** Product Diversity making it more competitive with conventional financial offerings
9. **Financial Stability and Crisis Resistance:** Avoiding Riba, excessive uncertainty (Gharar) and speculative transactions, contribute to financial stability and resilience during economic crises.
10. **Increased Awareness:**

8. Alternative Money Market, Capital Market

8.1 Money market

Most large scale businesses, especially financial institutions such as banks, manage their **liquidity** through the use of short-term sources of finance or investments.

The market which facilitates such **short-term borrowing** and investing are referred to as the *money market* in conventional institutions.

In other words, the money market is a component of the economy which provides short-term funds. The money market deals in short-term loans, generally for a period of **a year or less**.

8.2 Capital Market

Longer-term debt and equity markets are referred to as the *capital markets*. The presence of an actively traded market makes such investments readily realizable, highly liquid and therefore an ideal way to manage liquidity

The capital market is a type of financial market where longer-term debt and equity instrument like **stocks, bonds, debentures are traded**. They serve the purpose of long-term financing and long-term capital requirement.

8.2 Capital Market (Contd.)

Capital market It consists of two categories: **Primary market** where instruments are issued and **Secondary market** where these securities are traded between the investors.



8.3 Main participants of Money Market

The Islamic money market consists of several key participants, each playing a vital role in maintaining liquidity and ensuring Shari'ah-compliant financial operations. These participants engage in short-term financing, borrowing, and investment activities, all in line with Islamic principles,

- ❖ **Islamic Banks** : Manage short-term liquidity. Engage in Islamic interbank money markets.
- ❖ **Central Banks (Islamic or with Islamic windows)** : Provide liquidity support to Islamic banks. Issue Islamic money market instruments.
- ❖ **Takaful (Islamic Insurance) Companies** : Invest in Islamic money market instrument. Manage liquidity through different Islamic money market instruments.
- ❖ **Islamic Investment Funds** : Participate in the money market for short-term liquidity.
- ❖ **Corporations**: Issue Islamic Sukuk for short-term financing.
- ❖ **Government Entities**: Issue Shari'ah-compliant instruments like Sukuk to manage liquidity. Raise short-term funds in the Islamic money market.

8.4 Money Market Tools: Conventional

- **Interbank loans:** These **short-term** loans normally charge interest at the **interbank rate** e.g. London Inter-Bank Offered Rate (LIBOR) or its equivalent in different countries and jurisdictions.
- **Certificates of deposit (CD):** These enable investors who have locked money into fixed deposits to trade those investments. Typically have **slightly lower returns** than traditional deposits because of their tradability.
- **Treasury bills:** Often with maturities of **one year or less**, in sovereign markets, treasury bills are generally considered to be the **safest investments** possible in a country. These are normally issued at a discount and then are redeemable at face value which generates return for the investor.

8.4 Money Market Tools: Conventional (Contd.)

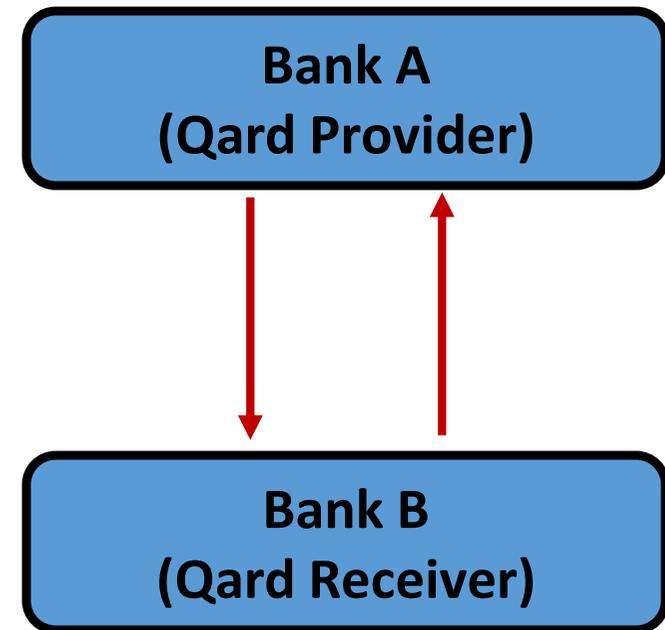
- **Treasury notes / bonds:** Marketable government debt securities that hold a fixed interest rate and are typically issued at a maturity between one and 10 years.
- **Repurchase agreements:** Popularly called Repo, these are arrangements whereby a institutions will agree to sell shares or bonds to an investor and simultaneously agree to repurchase the same securities at a later date for a specified higher price. The amount for which the shares / bonds are sold is normally below market value so that the lender has collateral in case of default by the borrower.

8.5 Money Market Tools: Islamic

Islamic money market tools for Islamic banks are designed to adhere to Shari'ah principles, avoiding interest (riba) and speculative transactions (gharar). Some key Islamic money market instruments include:

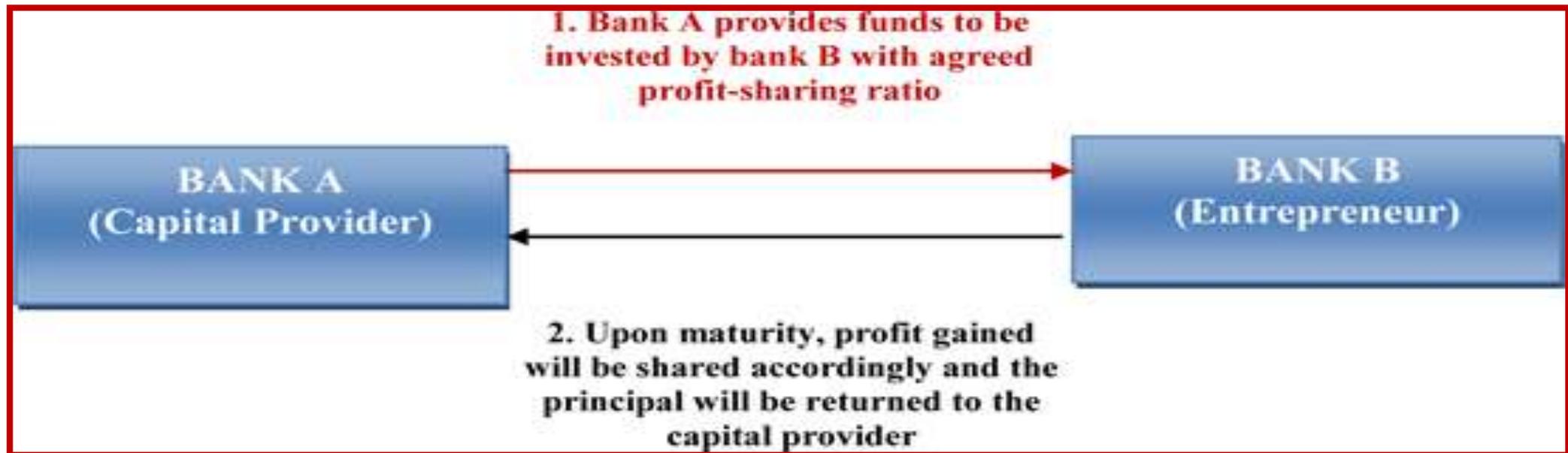
8.5.1 Qard Hasan (Benevolent Loan):

Interest-free loans provided for welfare purposes or short-term liquidity needs. It is a non-profit-based tool often used to enhance liquidity.



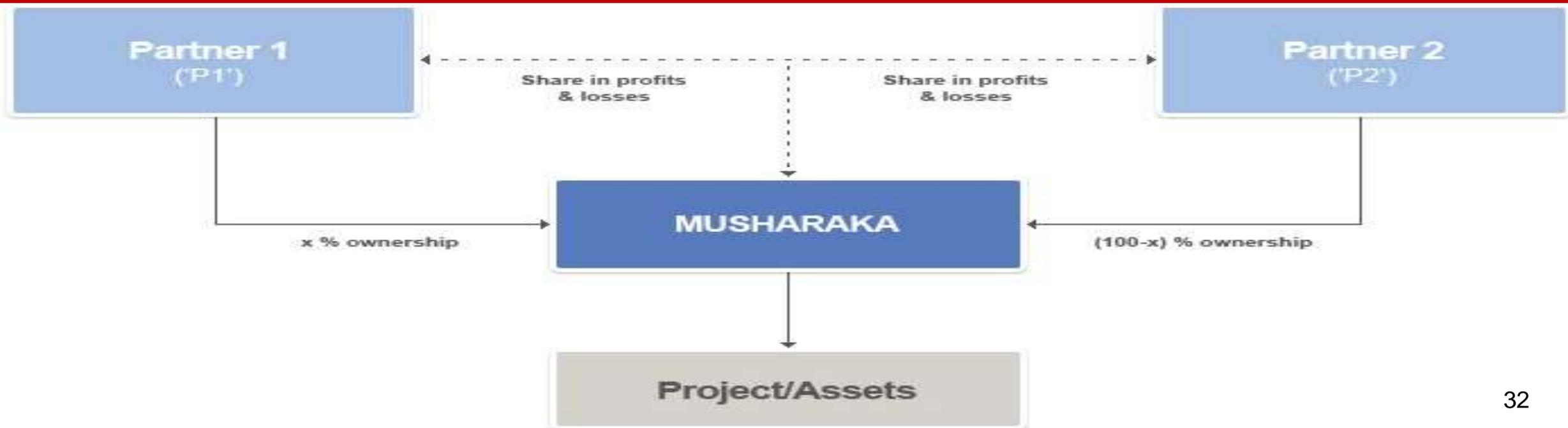
8.5.2 Interbank Mudarabah

With this contract, an Islamic bank with deficit liquidity will obtain required funds from another Islamic bank on a **profit and loss sharing (PLS) basis**. The managing bank will return the funds to the investing bank at the end of the contract. This amount will reflect the total capital plus profit in the agreed ratio that belongs to the investing bank. In case of loss the investing bank will have to bear the burden as per Mudarabah principles.



8.5.3 Interbank Musharakah

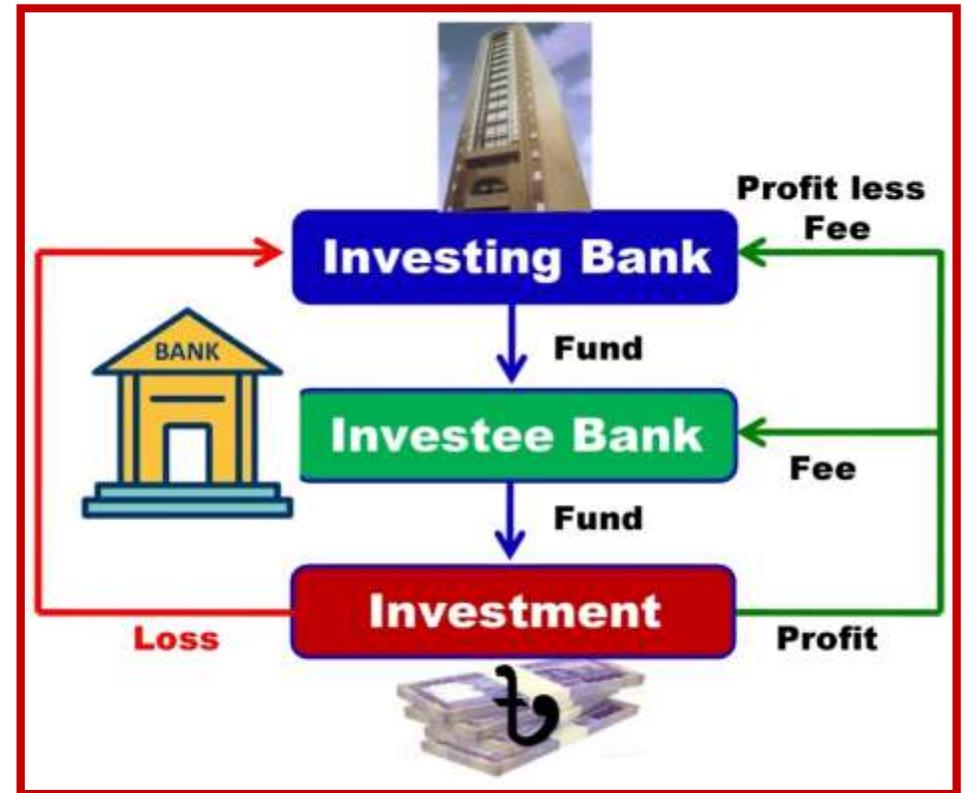
This is a short term **restricted partnership** where the banks are invited to invest in a special pool of assets on a pre-agreed profit sharing ratio. The investing bank will participate in the **funding pool** solely as an investor (sleeping partner). On the other hand, working partner will be the IFI which is in need of funds. At contract conclusion, profit will be shared as per the agreed ratio and loss as per the corresponding investment contribution.



8.5.4 Interbank Wakalah

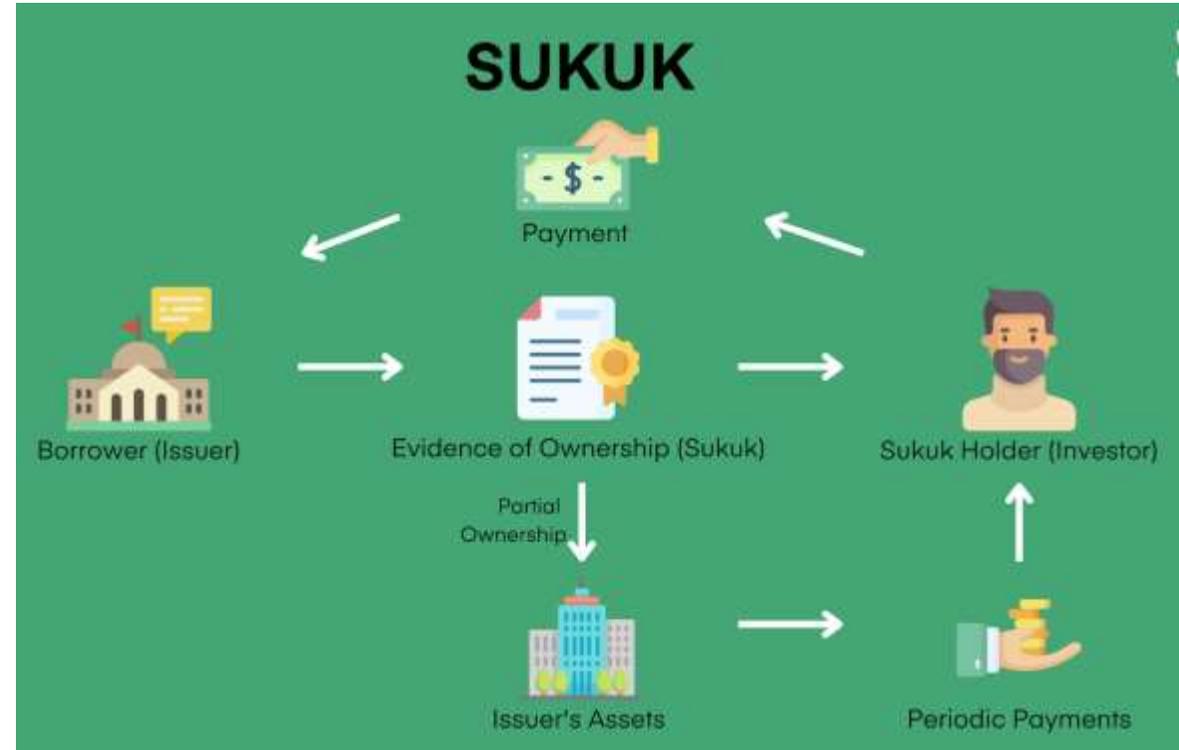
Islamic banks can place funds with another bank or institution on the basis of an agency agreement, where the agent invests the funds in Shari'ah-compliant activities.

In this form of financing, one bank will act as the **agent** of another bank (**principal**). The **principal bank will place funds** with the agent bank to invest in Shari'ah compliant projects. The principal bank gets the returns upon conclusion of the arrangement, after deducting **Wakalah fee** for the agent bank.



8.5.5 Sukuk

In the Islamic money market, Sukuk is used as a financial instrument that facilitates the raising of short-term capital for liquidity management by Islamic banks and financial institutions. Unlike conventional bonds, Sukuk represents ownership in tangible assets, usufruct, services, or an investment in a Shari'ah-compliant project. The returns are derived from the profits generated by these underlying assets..



8.5.6 Commodity Murabaha

This is essentially the sale of certain specified commodities, at a cost plus basis. Commodity *Murabaha* is based on the concept of *Tawarruq* and follows the following structure

