Code: 101 (Alternative Financial System)

SESSION-I

DIB, Part-I
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Alternative Financial System, It's Development
Alternative Islamic money market, capital market, money market tools

Presenter

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Session overview

The following important topics will be covered as per chapter 1 (Introduction to the Alternative Financial System), chapter 2 (Development of an Alternative Financial System) and chapter 5 : (Alternative Money Market) of Paper-101 of DIB Part-I:

1. Alternative Financial System
2. Islamic Finance
3. Development of Islamic Banking & Finance
4. International Infrastructure Institutions (AAOIFI, CIBAFI, IIFM, IFSB)
5. Features and Fundamental principles of Islamic finance
6. Objectives (*maqasid*) of Islamic finance
7. Superiority of Islamic finance
8. Position of Islamic finance in Bangladesh
9. Alternative Islamic money market, capital market, money market tools

1. Alternative Financial System

Alternative Financial System (AFS) refers accomplishing the financial needs of the people in a alternate way or in the 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 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 Shari`ah compliant manner.

In different jurisdictions, alternative finance is called in the different names, such as "Shari`ah-compliant finance/banking", "non-interest banking", "participation banking/finance" etc.

1. Alternative Financial System (Contd.)

Defining the Islamic financial system simply as "interest-free" does not provide a true picture of the system as a whole.

Prohibition of the receipt and payment of interest is the nucleus of an Islamic financial system, but Islamic banks adhere to many other principles of Islamic Shari'ah besides the prohibition of interest. It is supported by Islamic teachings advocating individuals' rights and duties, distributive justice, risk-sharing, avoidance of extreme uncertainty and the sanctity of contracts.

Overall, it is an integral part of the Islamic economic system which itself is driven by the tenets of Islamic Shari'ah.

2. Islamic Finance

Islamic finance consists of three major categories :

2.1 Islamic banking – As opposed to the conventional banking system and based on the principles of trade and partnership. Depending on the nature of the contract used, the Islamic bank can be a trader, a lessor, an agent or a partner with its customers.

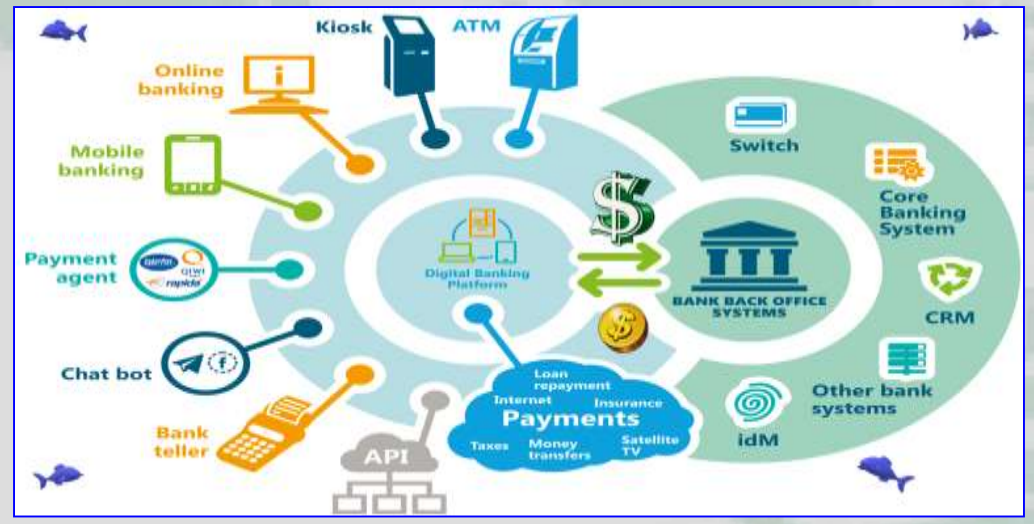
2.2 Islamic insurance (Takaful) –Islamic insurance or Takaful achieves the objective of **risk mitigation** without the prohibited elements of conventional insurance (i.e. Gharar, gambling and Riba).

2.3 Islamic capital market – The Islamic capital market functions as a parallel market to the conventional capital market for capital seekers and providers. The **main difference** with the conventional capital market is that it is free from prohibited elements and activities such as Riba, Gharar and Maisir (مَيسِر) / Qimar

2. 1 Difference between the ADC and AFS

The term alternative delivery channel (ADC) denotes **those channels that expand the reach of services beyond the traditional bank branch channel**, ADC has emerged as a result of innovations in information and communication technology and a shift in consumer expectations. Such as ATM, CRM, Online Banking, Debit Card, Credit Card, internet banking, mobile banking, Call Centre, Social media etc.

On the other hand, Alternative Financial System (AFS) denotes the **system** that meets all type of financial needs of the people in alternate ways to the traditional financial system do.



AFS

ADC

2.3 Difference between the ADC and AFS (Contd.)

Particulars	ADC	AFS
Definition	Expansion of services beyond the traditional channel	Financial system that meets financial needs in Shari`ah compliant way and includes Islamic banking, takaful and capital market.
Origin	Absolutely new	Back to the era of Prophet (PBUH)
Scope	Limited. Part of Service	Broad. Part of economic system
Products	ATM, CRM, Online Banking, Debit Card, Credit Card, internet banking, mobile banking, Social media etc.	AWCA, MSA, MTDR, Murabaha, Musharaka, Salam, HPSM etc.
Main Focus	On Technology	Shari`ah Compliance, Riba avoidance
Main Objective	Easiness, quickness, accuracy, inclusion	Ensuring welfare, prevention of harm

3. Development of Islamic Banking & Finance

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

  "Al-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." (Reported in al-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)

3. Development of Islamic Banking & 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 ares 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 Cooperations (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).

3. Development of Islamic Banking & 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 (**IBBL**), 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.

4. International Infrastructure Institutions

1975 — Islamic Development Bank
Fosters the economic development and social progress of member countries and Muslim communities in accordance with the principles of Shari'ah

1983 — OIC Fiqh Academy
Studies contemporary problems from the Shari'ah point of view and finds the solutions in conformity with the Shari'ah

1991 — Accounting and Auditing Organisation for Islamic Financial Institutions
Prepare accounting, auditing, governance, ethics and Shari'ah standards for Islamic financial institutions and the industry

2001 — CIBAFI
General Council for Islamic Banks and Financial Institutions
Supports and promotes the Islamic finance industry through information, media, research & development, consultancy and human resources development

2002 — Islamic Financial Services Board
Promotes and enhances the soundness and stability of the Islamic finance industry by issuing global prudential standards and guiding principles for the industry

2005 — International Islamic Financial Market
Focuses on the standardisation of Islamic financial products, documentation and related processes

2005 — International Islamic Rating Agency
Assists the Islamic finance industry to gain recognition locally and international as strong and capable institutions, adhering to greater standards of disclosure and transparency

2005 — International Islamic Centre for Reconciliation & Arbitration
Settles financial and commercial disputes through reconciliation or arbitration

2008 — ISRA
International Shari'ah Research Academy for Islamic Finance
Promotes applied research in the area of Shari'ah and Islamic finance

2010 — International Islamic Liquidity Management Corporation
Creates and issues short-term Shari'ah compliant financial instruments to facilitate effective cross-border Islamic liquidity management

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;

AAOIFI
ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS

4.1 AAOIFI (Contd.)

AAOIFI key facts and figures

1991

Founding year

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

140+

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)

114

Standards and techical 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)

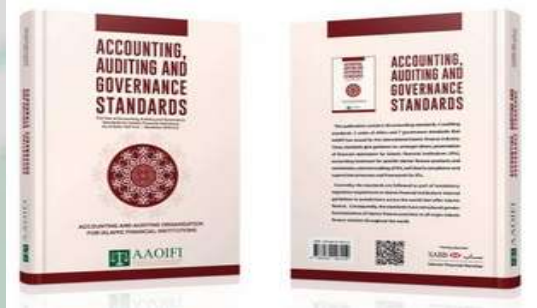
35+

Countries / regulatory jurisdictions Footprint

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

Ref. AAOIFI Footprint Report 2020, P-28

4.1 AAOIFI (Contd.)



Issued **114** standards and technical pronouncement in the areas of Shari'ah, accounting, auditing, governance and ethics upto 31 August, 2020.

Sl	Areas	No. of Standards
1.	Shari'ah	59
2.	Accounting	31
3	Auditing	8
4.	Ethics	3
5.	Governance	13
	Total	**114**

4.2 CIBAFI

General Council for Islamic Banks and Financial Institutions
CIBAFI
المجلس العام للبنوك والمؤسسات المالية الإسلامية

- 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 International Islamic Financial Market (IIFM)

السوق المالية الإسلامية الدولية
International Islamic Financial Market

IIFM is a standard-setting body of the Islamic Financial Services Industry (IFSI) focusing on standardization of Islamic financial contracts and product templates relating to the capital and money market, corporate finance and trade finance segments of the IFSI.

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 **14 standards** on different products of Islamic finance.

4.4 IFSB

ISLAMIC FINANCIAL SERVICES BOARD

An international standard-setting organization which started operations in **2003.** It promotes and enhances the **soundness and stability** of the Islamic financial services industry by issuing global prudential **standards** and **guiding principles** for the industry, broadly defined to include **banking**, **capital** markets and **insurance** sectors.

The IFSB also conducts **research** and coordinates initiatives on industry related issues, as well as organizes **roundtables**, **seminars** and **conferences** for regulators and industry stakeholders.

4.4 IFSB (Contd.)

- **Headquarter**: Kualalampur, Malaysia
- **Chairman**: Dr. Reza Baqir, Governor of State Bank of Pakistan.
- **Secretary General:** Dr. Bello Lawal Danbatta
- As at June 2022, the **188 members** of the IFSB comprise **81** 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.

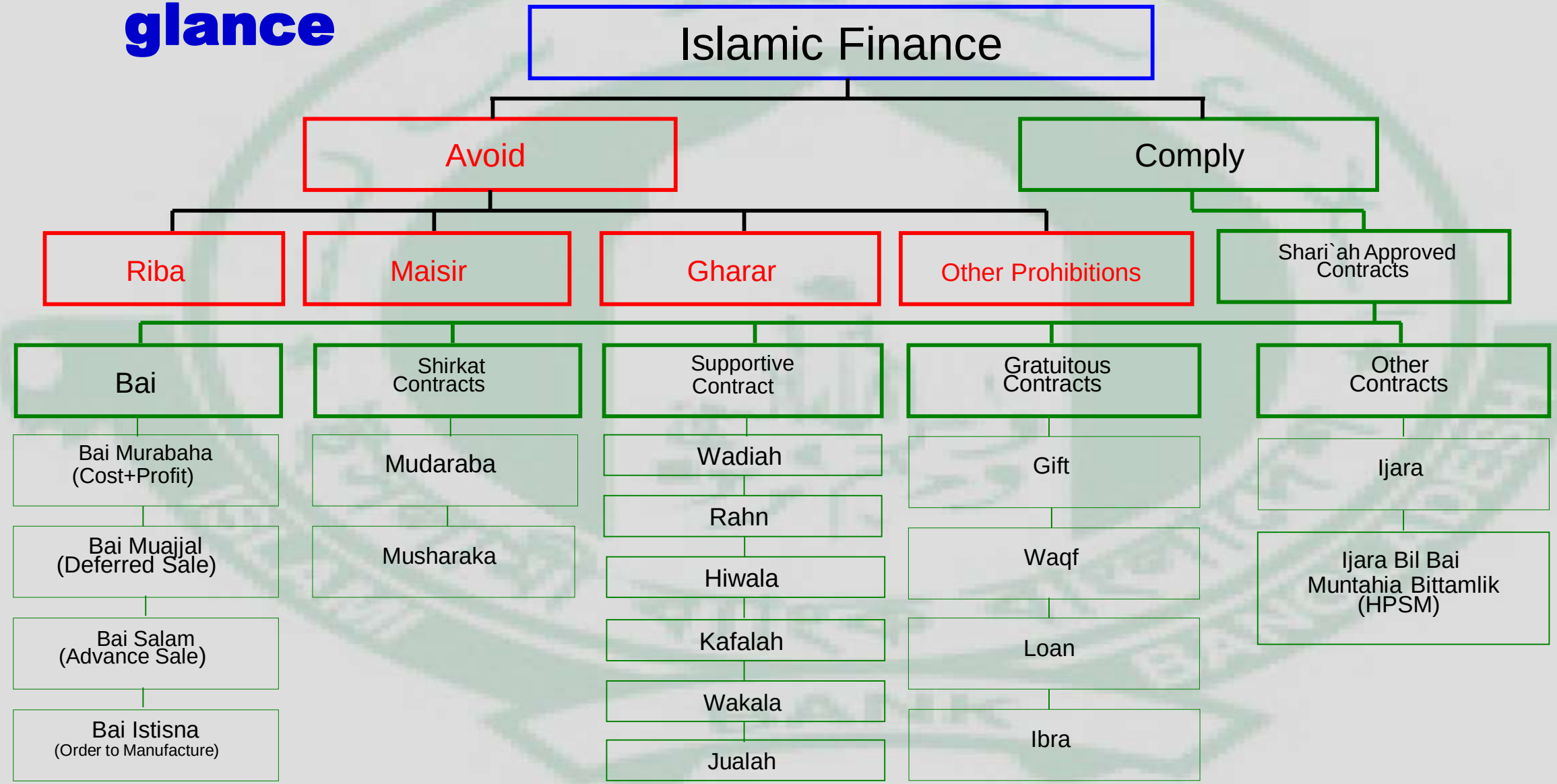
5. Features and Fundamental principles of Islamic finance

The **conventional** financial system **focuses primarily** on the economic and financial aspects of transactions with their **material outcomes**, the **Islamic system** places equal emphasis on the **ethical, moral, social, and public welfare**.

The basic **framework** for Islamic finance is a set of rules and laws, collectively referred to as **Shari`ah**, governing economic, social, political, and cultural aspects of Islamic societies.

The fundamental principles of an Islamic financial system can be **summarized as follows**:

5. Fundamental principles of Islamic finance at a glance



6. Objectives (Maqasid) of Islamic finance

Objectives of Islamic finance

Religious Objectives

- Freeing people from the curse of *Riba*
- Collecting and Distributing *Zakat* Fund
- Collecting *Quard* Fund
- Providing *Quard*
- Collecting Waqf fund and Distributing *Waqf* Profit.

Social Objectives

- Distributive Justice
- Alleviating Poverty
- Removing Social inequality
- Improve Standard of living
- Saving the People & Planet.

Financial Objectives

- Safe keeping of public money (Hifzul Maal)
- Offering viable and Competitive product
- Profit Maximization
- Sustainability
- Increasing stakeholder value

7. Superiority of Islamic finance

- **T**he **biggest privilege** is that the **Muslims can take financial service avoiding interest** and which brings benefits not only here but also endless rewards in the Hereafter.
- Islamic finance deals with **real economy**. That means it provides **asset based / asset backed** investment facility which strengthen the overall economy.
- In Islamic banking, in case of *Shirkat* mechanism, the burden is not imposed solely the entrepreneur. Rather, it becomes a **profit/loss sharing** project.
- The people who did not involved themselves with banking because of interest, are also getting involved with interest free banking. So Islamic finance is **inclusive** in real sense.
- "**Integration of ethical and moral values** with its banking operation. The Islamic bankers behavior should be consistent with the moral and ethical standards laid down by the Islamic Shari'ah.
- In Islamic finance, all harmful and injurious acts must not only be avoided in all cases but they must also be prevented.

7. Superiority of Islamic finance (Contd.)

- Unlike the conventional banks, the financing of Islamic banks are restricted to permissible and **useful goods and services** and refrain from financing **alcoholic** beverages and **tobacco** or morally unacceptable services such as **casinos** and **pornography**, irrespective of whether or not such goods and services are legal or not in a given country.
- **Marketing** policy in Islamic financial system also has unique features and is beneficial to the society
- IFIs, apart from paying zakat on their own assets, collect **zakat/waqf** from the people/depositors and spend it on public welfare.
- IFIs in different countries of the world are playing a leading role in the welfare of humanity by **financing the poor** and vulnerable communities. In Bangladesh, Islami Bank Bangladesh Limited is working tirelessly to improve the fortunes of poor people through **RDS** and **UPDS**.

8. Position of Islamic finance in Bangladesh (Jun'22)

Srl	Nature of IFI	No. of IFI	No. of Br/Window
01.	Full Fledged Islamic Bank	10	1682
02.	Conventional Bank with Islamic Banking Br.	9	45
03.	Conventional Bank with Islamic Banking Windows	13	480

Table 1.2 Performances of Islamic Banks Compared to All Banks in Bangladesh

(In Billion BDT)

Items	April-June 2022P			January-March 2022
	All banks	Islamic banks	Share of Islamic banks among all banks (%)	Share of Islamic banks among all banks (%)
	1	2	3=(2/1*100)	4
Total deposits	15743.78	4123.41	26.19	28.21
Total investment (loans & advances in conventional banking system)	13387.26	3818.29	28.52	27.78
Remittances	497.83	157.17	31.57	30.96
Total excess liquidity	1892.68	260.09	13.74	14.19
Total number of bank branches	10963	2207.00	20.13	19.69
Total agricultural credit	73.30	17.18	23.44	27.13

Source: Statistics Department, MPD, BRPD and ACD, Bangladesh Bank.

(Ref. https://www.bb.org.bd/pub/quaterly/islamic_banking/islamic_apr-jun2022.pdf)

Besides the above, there are 8 full-fledged Islamic insurance companies and 13 Islamic insurance windows operating takaful in Bangladesh. (Ref. http://dx.doi.org/10.24200/jonus.vol7iss1pp100-113, P-104)

9. Alternative Islamic Money Market, Capital Market, Money Market Tools

9.1 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**.

9.2 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.

9.2 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.

9.3 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.

9.3 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.

9.4 Money Market Tools: Islamic

Profit sharing investment reserves

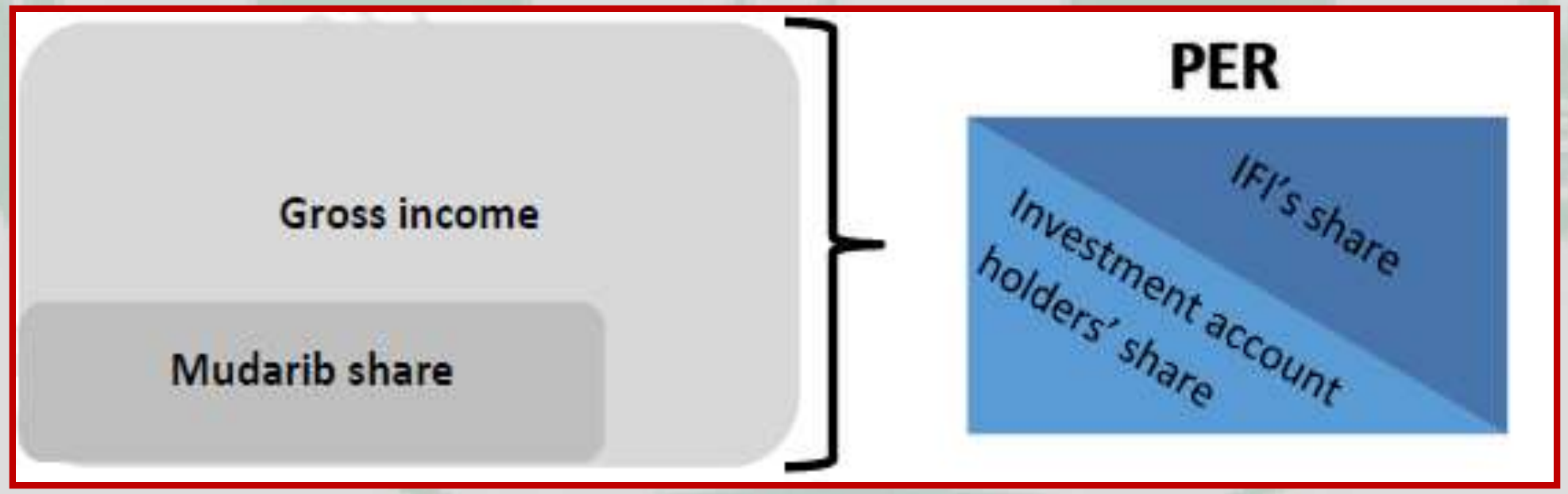
Banks can use **reserves** to meet or cover liabilities and act as buffers in times of crisis. As Islamic banks operate in the same market as conventional banks, there is a need for them to match market returns on investments. AAOIFI standards require that IFIs keep **two different types** of reserves to ensure adequate liquidity and to enable them to distribute profit that is in line with market expectations.

These two reserves are the **profit equalization reserve (PER)** and the **investment risk reserve (IRR)**:

9.4.1 Profit equalization reserve (PER)

This is the amount appropriated by the Islamic bank out of the Mudaraba income, before allocating the Mudarib share, in order to **maintain a certain level of return** on investment for investment account holders and increase owners' equity.

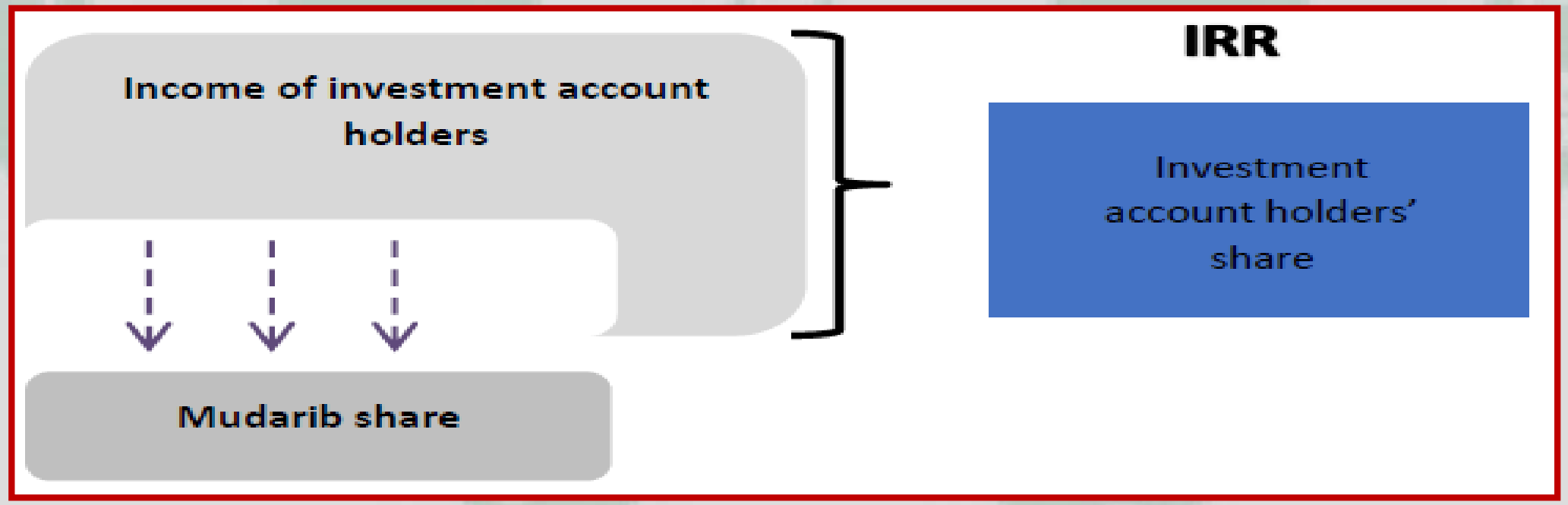
(Ref. AAOIFI Shari'ah Standard No. 40)



9.4.2 Investment risk Reserve (IRR)

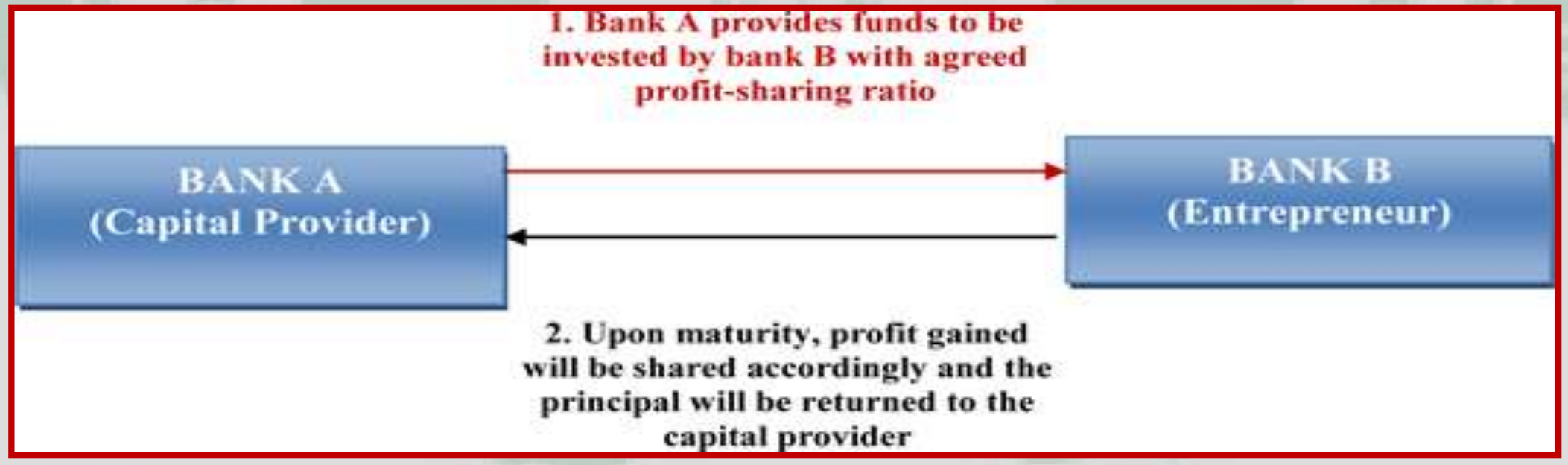
"This is the amount appropriated by the Islamic bank out of the income of investment account holders, after allocating the Mudarib share, in order to **cater against future losses** for investment account holders."

(Ref. AAOIFI Shari'ah Standard No. 40)



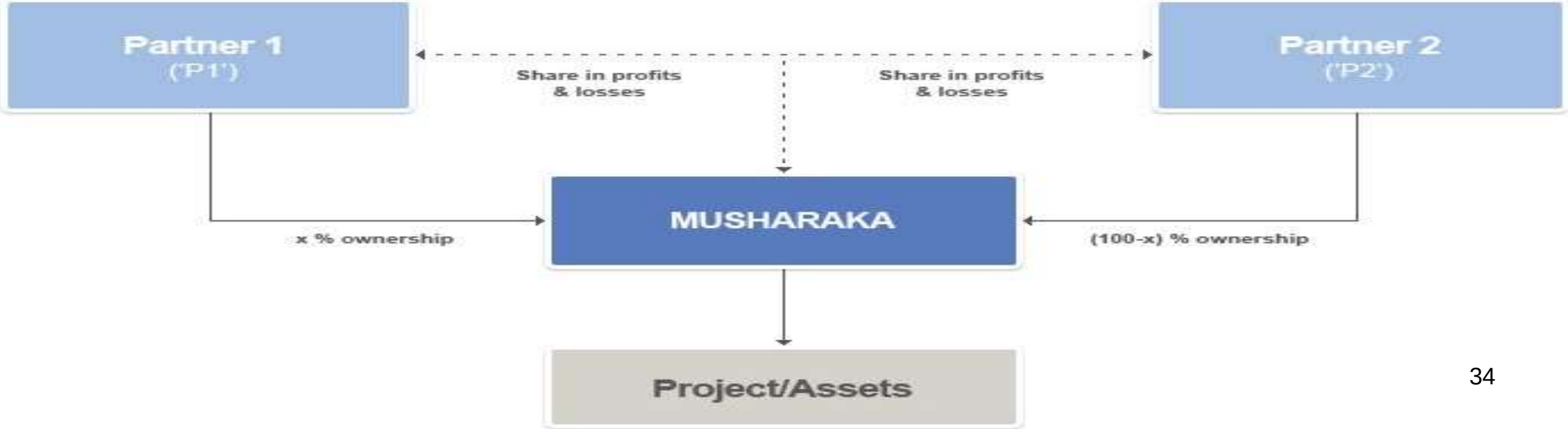
9.4.3 Interbank Mudarabah

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.



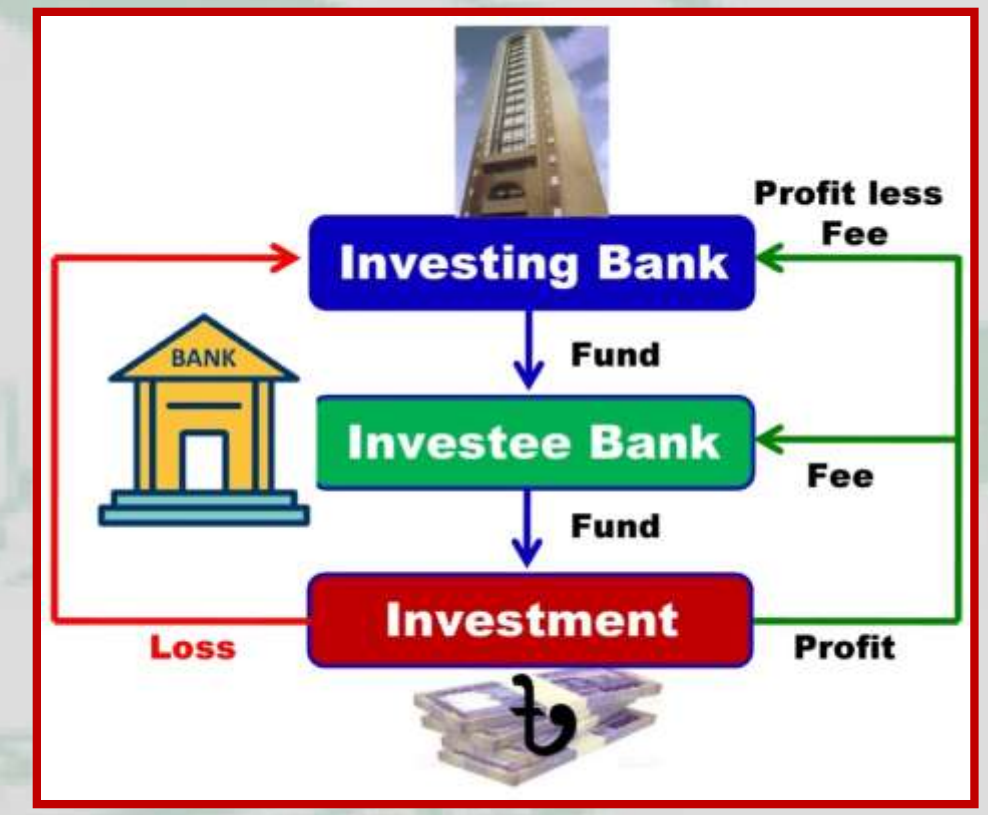
9.4.4 Interbank Musharakah

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.



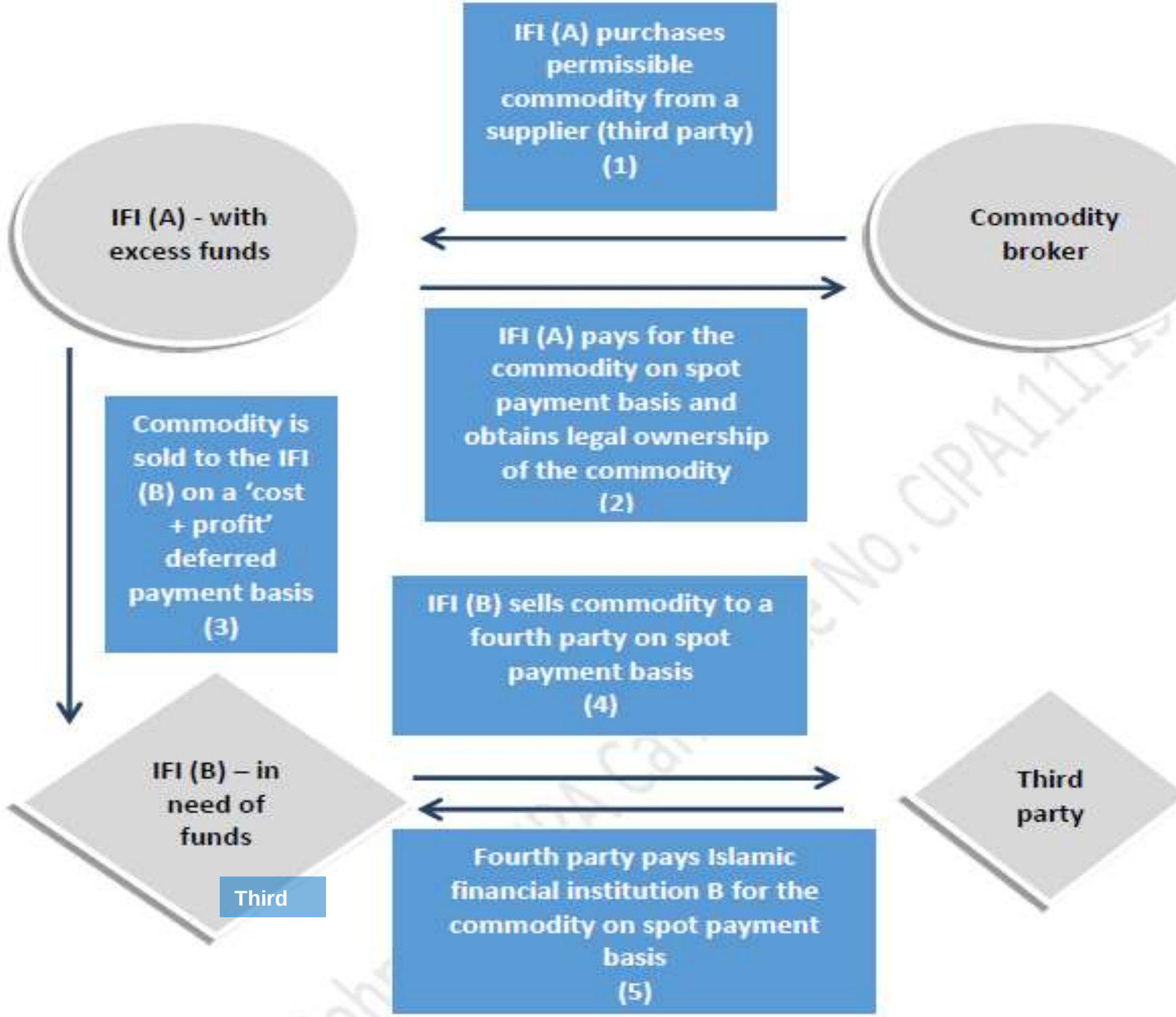
8.4.5 Interbank Wakalah

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.



9.4.6 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



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