



History and role of Islamic finance

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General Note

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ABSTRACT

Islamic banks have been created to cater to the growing demand, driven by globalization and the vast wealth of some Muslim states in the Middle East and Southeast Asia, and Islamic finance has moved from a niche position to become a mainstream component of the global banking system. Islamic banking refers to a financial system which is consistent with principles of Islamic law (or 'sharia') and guided by Islamic ethics. This paper presents Islamic finance's role in the new world order.

Keywords: Finance, Islamic, banks.

1. INTRODUCTION

Islamic finance is a growing phenomenon, which came into existence to satisfy the financial needs of devout Muslims (1.6 billion Muslims around the world) who observe the prohibition of Riba (usury). Many economists have studied the macro-economic properties of banking institution in the framework of an isolated and ideal Islamic economy. In the age of integrated global financial markets, the instantaneous transformation of an entire financial sector to profit-and-loss sharing is very unlikely: so what is the outlook for Islamic banking?

However, the Islamic economic principles of sharing risks and rewards, and participating in the wealth creation activity via equity rather than debt has provided a solution that eliminates debt in its existing interest based form while continuing to promote entrepreneurship and creativity in the economic cycle. This requires equity participants to actively benchmark proposed projects

against moral standards (social analysis) in addition to the financial parameters (risk analysis) leading to a clear comprehension of the wealth creation process at an individual level. In the Islamic economic model each individual is involved in the economic activity. In comparison, the debtor tends to be only remotely involved in scrutinizing the business proposal in the debt bond model – broadly content with earning interest on the loan regardless of the social and financial implications of the project.

2. LITERATURE REVIEW

Khan (1986) has noted that the abolition of interest-based transactions is not a subject alien to Western economic thought. Fisher (1945), Simons (1948) and Friedman (1969) have argued that the current one-sided liability, interest-based financial system can be fundamentally unstable.

There are many such examples; the German hyperinflation of the 1920s, oil shock inflation's in Europe of the 1970s; and banking crises in Japan, East Asia, Russian and Argentina default and Enron bankruptcy, and so on.² The occurrence of crises is the result of a complex of factors emanating from over exuberance, greed, underestimation of risk, overexposure, currency failures, asset depreciation, faulty regulation, illiquidity, macroeconomic shocks and accountancy maladministration. Zarqa (1983), Khan (1986), Chapra (2000), El-Gamel (2000) have illustrated the macroeconomic stability that can form a profit and loss sharing system, an Islamic form of banking would replace interest-based transactions that characterize Western transactions.

3. OBJECTIVES OF THE RESEARCH

The main objectives of the research are as follows-

- To know about the History of Islamic Finance.
- To know about the Role of Islamic Banks in the New Financial Order.

4. RESEARCH METHODOLOGY

In this research paper, secondary data was used which was collected from various secondary sources such as books, journal, internet etc.

5. DATA ANALYSIS

5.1. History of Islamic Finance

In the first phase during the 19th century, the crucial question was: How to reform traditional Islamic societies to compete or resist the Western cultural and material domination? As noticed in Abdel Rahman el Jabarti, who were describing the invasion of Napoleon in Egypt, The West was not a dominant power by the technology only but also by a vision of the World (Al-Jabarti, 1975). It means a set of fundamental assessments, which underpin capitalism. Many Muslim intellectuals understood that reforms would need a change in the general vision or ways to apprehend reality. Old vocabulary which insists on "otherness" of the West (for ex. Al ifranj, rum, kafir, could not longer serve to understand the transformation. New conceptions and new vocabulary were necessary. For example, the very term ummah which refers to the community of Muslims was not relevant describing either the emerging nations (Egyptian, Syrian,;) nor the very concept of society. Islamic thought had to describe "societies" functioning in its inner logic. Changing a society needs to view it as a social device and to understand its logic. So many questions arose. For example, one of the questions was: How to change property structure in order to foster efficiency? How to introduce a part of private property especially in rural societies in order to improve the production but at the same time respect the rulings of sharia and the idea that land is a resource given by God as a trust?

Another important problem was concerning the educational system. It was clear that the innovative transformations needed new skills and competences. But Education had to be also a bulwark against all the dangers of the rationales behind the capitalist transformation. This would counteract the disintegrative tendencies of modernity. It is interesting to see that both property and educational issues participated in the construction of the individual as a central category of thinking and also in practice. It means that Jabarty's thought is elaborating on one of the main characteristic of modernity, i.e. individualism.

If some intellectuals were very attached to the tradition and mainly worried by the compliance of new rules with the Sharria, many others considered that the development of Muslims countries and the material well being of Muslims would be the main criterion for reforming the society. It is the case for example of Jamal Eddine al Afghani (1838-1897). In some case the benefit of the Muslim community as a whole was considered as much important as the strict respect of the rulings of Sharia. So the first phase of Islamic thought during the nineteen-century was mainly devoted to create a new set of concepts and even a new vocabulary to adapt the traditional Islamic society and to challenge the intrusion of the West.

5.2. The Role of Islamic Banks in the new financial order

The mechanism of Islamic banks is particular (Aggarwal & Yousef, 2000; Archer & Karim, 2006) since the applicants are not the bank's creditors, nor are they the shareholders or the stakeholders whose deposits are paid in the form of a participation through the bank's profits. They are stock companies whose balance sheet consists of shareholders' equity, deposits and loans based on the sharing of profits and losses (Dar & al., 2004). The most obvious difference is that the applicant in an Islamic Bank does not know a priori the amount of his future earnings. Since the applicants are not allowed law wise to receive a fixed interest rate, and that they will share the profits with the bank or bear losses on their deposits, funds should theoretically be regarded as the equity (Archer & Karim 2009). If we place ourselves in this perspective, we can indeed wonder if Islamic banks must be regarded rather as financial institutions or banks. In fact, Islamic banks have the ability to give out loans, knowing that these credits do not generate any interest. Therefore, they have a power of creating money, the level of which can be as equally as important as the circulation area of private money. From this point of view, Islamic banks perform the same functions as in the conventional system and can therefore be considered as second-tier banks which will have to finance their interbank debt with funds from the Central Bank. Therefore it is not inconsistent to believe that the same prudential criteria of conventional banks are followed by Islamic banks (Zangeneh & Salam). Some authors think that we need to be more severe because of the relative novelty of this type of instrument. Others rather think that the common prudential rules are not necessary because of the need for the Islamic Bank to be much more cautious on their transactions due to the articulation between financial and real assets. But this argument can be turned because the Islamic Bank in contrast to the conventional Bank may also carry the risk of credit applicants. The consequence of the ethical and religious Islamic finance dimension is the existence of an original supervision organ, the Sharia committee, which their constitution and in mission still needs to be defined (Ould Sass, 2010).

6. CONCLUSION

"Islamic economics" focused mainly on banks, banking systems and finance. Why Islamic Thought doesn't participate enough in the global discussions on an alternative model became clear. Three reasons can explain this situation. First of all: "Islamic economics" developed in the last forty years is closely linked with the neo-liberal turn of Capitalism in the 80's, based on huge oil revenue. But this time is over. We are entering a new post neo-liberal phase and whose problems are sustainable development and social responsibility based on new forms of governance. A new Islamic thought should then emerge around the concept of "Islamic governance". Second: the huge recent development of Islamic economics focused on sharia compliance. It means how to comply Capitalism with Islam but without contesting the fundamental assumptions that undermine Capitalism. The problem now is not to adapt Islam to Capitalism. The Problem is to transform Capitalism and find an alternative system and Islamic thought has a lot to say on that issue. Last reason; Islamic Economics focused mainly on Islamic societies and Islamic problems. It was interesting when the World economy was split in different regions. But Islamic world is now integrated in the World system. And so Islam might have something to say to the World as a Whole.

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