Ch.1
Shari’a and Islamic Economic System

I. Islamic Way of Life

◈ *Allah* (swt) creates man and designates him as khalifah (agent) on earth for the purpose of worshiping (serving) *Allah* in accordance with his commands. Man’s duties and responsibilities are clearly designated, and all necessary means to conduct and practice these duties and responsibilities are provided with clear guidance, reminders, and criteria of good and evil. The rewards and retributions in the final judgment with the commensurate with obedience and transgression are made known. Hence, it is man’s free will and choice to determine which path he would decide to choose.

◈ Islam came as guidance to all humankind with a set of fundamental principles of belief and comprehensive rules of conduct that governs humankind’s behaviors and actions.

◈ Based on these principles and rules, Islam provides a complete set of systems and processes that are practical, integrated, and cohesive in a sense that we cannot implement one system in isolation of the others. These systems organize relationship between man and his Creator, man and universe, man and environment, man and society, and man’s relation with himself.

◈ All systems and processes are in consistent with the core and fundamental pillars of Islamic faith.

◈ The most fundamental pillar of the Islamic faith is the belief that there is no god but *Allah* (swt), the one and the only Creator and Sustainer of the whole universe, and Mohammed (pbuh) is his last and final messenger.

◈ Another important pillar of the Islamic faith is the belief that this life is just a temporary one and the eternity life is in the hereafter. Therefore, all our activities should be aimed at maximizing our “benefits” beyond the short span of this earthy life and towards the ultimate happiness and perfect eternity life. This belief has very important implications that distinguish the economic and social behavior of the true Muslim believer from others.
✧ The third important pillar is the belief in *Qadar* (fate) and all our actions and activities are only a means to achieve the objectives we aimed at, but the results are contingent upon *Allah* (swt). Thus, if the targeted goals and objectives have not achieved, after utilizing all proper resources and efforts in the most efficient way, the Muslim would not be disappointed because he believes that there is an ultimate wisdom beyond the materialistic reasoning of events. And if these goals and objectives are achieved, the Muslim truly believes that these achievements are not only due to his good planning, right strategies or smart actions but before and after all of these is due to *Allah*’s blessings and guidance. The belief in the *Qadar* results in moderation of our reactions, humbleness towards others, avoidance of arrogance in our behavior, and acceptance of all events good or bad in a big sense of satisfaction.

✧ Unlike secular way of life, which reduces religion to private matters between individual and God, and emphasizes the dichotomy between religion and human life, one of the most fundamental principles of Islam is that there is no separation between temporal and religious matters. This implies that the compliance with *Shari’a* is the basis for not only religious worship and rituals but also business practices and behaviors.

✧ Following the Islamic faith in its totality would result in the man’s awareness of the presence of *Allah* (swt) in all of his actions. As a result of this awareness, all man’s thoughts, behaviors, and actions would be accomplished with a sense of *taqwa* (pietism, God-fearing) which prevents him from doing wrong deeds or committing sins. Real *taqwa* leads man to the perfect life that is in harmony of the individual’s spiritual, intellectual, and materialistic aspects and that leads to harmony among the man, society, and environment.

✧ Islamic society can be described as faithful to *Allah*, practicing and promoting Islamic values and rules, unified, moderate, cooperative, commanding the good and forbidding the evil.

✧ This Islamic society has a just, moral, and viable social order that guarantees equal opportunities to all, and implements the equality of rights and
obligations toward the Islamic community as well as each of its members in particular and to the entire humanity in general.

- Islamic society promotes freedom, tolerance and justice (*Adl*). The interest of the individual is protected as long as this interest does not contradict the general interest of the society. Protection of the interest of society is more important than individuals’ interests.

**II. Shari’a Rules**

- Because life is considered as one and indivisible, Islam integrates all of man’s needs, inclinations, and desires with no distinctions between spiritual and temporal.

- Islam may be perceived as comprising three basic sets of components:

  1. **Aqida (faith):** It deals with all forms of faith and beliefs by Muslims in *Allah*.

  2. **Shari’a (Islamic law):** The Arabic word Shari’a means a system of Islamic law. It outlines all forms of practical actions by Muslims. Shari’a is divided into two components:

      a. **Ibadat (worships, rituals),** which is a man-to-*Allah* relationship
      b. **Mu’amalat (transactions),** which includes various forms of man-to-man relationships; Muamalat could be divided into:

         i. Social System,
         ii. Political System,
         iii. Cultural System,
         iv. Civic System, and
      v. Economic System, which include: business, banking and finance activities as well as other economic activities

  3. **Akhlq (moral and ethics):** Akhlaq refers to the Islamic code of conduct. It is concerned with ethics, morality, and behavior and attitudes (honesty, kindness, sincerity).
✧ All components and systems are integrated and intercorrelated, forming the comprehensive Islamic system; for example, Zakat is based on faith and it is part of Ibadat, but also strongly related to economics, social, civic, and political systems.
✧ Islam is a system of beliefs that provide Muslims with a set of rules, which regulates their entire way of life. These rules and regulations are found in the Islamic law known as Shari’a.
✧ The purpose of Shari’a is to promote and protect the interest of individuals and societies by bringing benefits and preventing harm in relation to their necessities, needs and wants.
✧ Shari’a is derived from the following five resources:
✧ The primary resources which include
  1. The Qur’an
  2. The Sunna: words and practice of the Prophet (pbuh)
✧ Scholars added three other important secondary sources:
  1. Ijma’ (consensus): The consensus of the Islamic scholars on a particular issue
  2. Qiyas (analogy): the application of accepted principle by analogy to a new case
  3. Ijtihad (opinion): The opinion of authentic Islamic scholars on particular issues
✧ There are other sources of Shari’a that they are relevant to the above but with secondary importance such as Istihsan (preference), Maslaha (public interest), and Orf (customs).
✧ It must be clear that all secondary sources (the important and the less important ones) cannot introduce any rules that contradict Qur’an and/or Sunna.
✧ The Shari’a is not a codified body of law but it is capable of development and interpretation. Although Shari’a is clear, its translation into modern, rapidly evolving financial practice is inevitably open to different interpretations.
✧ The Shari’a laws derived from the above resources are arranged into five
level categories. These categories are:

i) *Fardh* or *Wajib* (obligatory)
   An obligatory duty, which, if not performed, is deemed to be punishable. If performed with good intention it is rewarded.

ii) *Mandoob* or *Mustahab* (recommended)
   An action, which is rewarded but, if not performed, is not deemed to be punishable

iii) *Ja’iz* or *Mubaah* (indifferent, neutral)
   An action, which is permitted, with the *Shari’a* being indifferent, neither encouraged nor discouraged. Most of human actions fall in this category.

iv) *Makrooh* (reprehensible, disliked)
   An action, which is disliked but not deemed to be punishable

v) *Haraam* (forbidden)
   An action, which is absolutely forbidden and deemed to be punishable

✧ These five categories of valuation help the man to distinguish between the righteous actions and the evil ones and choose at his own free will which path to follow.

✧ The Islamic *Shari’a* provides rules that encompass the allocation of resources, management, production, consumption, capital market activity and the distribution of income and wealth. It also defines, in broader terms, a general framework for designing monetary and banking systems.

✧ *Shari’a* rules give high priority to applying moral and ethical standards in all types of economic activity.

✧ Islamic economics and finance have evolved as a result of some *Shari’a rules* which can be summarized as follows:

1. **Prohibition of *Riba***
   - Technically, *riba* (usury or interest as it is commonly known) refers to the addition in the amount of the principal of a loan. *Riba* is forbidden in
Islam. Qur’an and Sunna prohibit the transactions that are based on charging of *riba* or the payment of it.

- Since *riba* is prohibited, all banking and financial activities must avoid interest-based transactions. Instead of interest, Islamic financial system is based on modes of financing based on risk sharing partnership rather than debt financing. Bank earns profit (mark-up) and fees on financial services it extends to customers. Depositors earn a share of the Bank’s profit as opposed to interest. Most of the activities of the conventional financial institutions are interest-based financing (We will discuss *riba* thoroughly in later section).

- In other words, while conventional financial institutions "trade" in money (buying money from depositors and selling money in the form of loans), Islamic financial institutions must "trade" in real assets or services. Islamic financial institutions, it is not allowed to charge for the mere use of money.

- Prohibition of *Ribā* is the centerpiece of Islamic monetary policy.

2. **Avoidance of Gharar**

- Shari’a prohibits the excessive uncertainty in contracts – e.g. entering into a transaction whose consequence is out of usual trade norms. Hence, any contract based on a future uncertain event such as hedging, dealing in derivatives, etc, within Islamic banking, is not generally allowable.

Conventional financial system allows trading and dealing in derivatives of various forms.

- Clarity of intentions and transparency is imperative in all dealings in the Islamic society. Any transactions that one party holds necessary information, which may affect the decision of the other party, is considered void from the Islamic perspective.

- Deception is totally prohibited in all types of transactions.
3. **Avoidance of Exploitation**
   o All types of relationships and contracts must reflect justice and fairness. Oppression is highly condemned in Islam. Those who take advantage of the need for people to work and make them work more hours than necessary in unhealthy and unsafe environment with very low payments, or those who take the advantage of people's need for a specific good or service to increase its price unreasonably high are considered oppressors.

4. **Accountability**
   o Since guidance is clear and all means are provided, all human kind and Muslims alike are accountable for their actions. Man has rights for and obligations towards himself, his community, environment, and above all towards his creator Allah (swt).
   o As long as the man is adult and rational, he is considered accountable for his actions and behaviors.

5. **Zakat as an Important Pillar of Islamic Shari’a**
   o **Zakat** is one of the most important pillars of Islamic faith. The term “Zakat” is derived from the Arabic word meaning pure. It is equivalent to 2.5 percent of a Muslim’s annual income. Zakat is levied upon only the Muslim members of the state and is paid by them as a religious duty and act of worship to Allah Almighty.
   o Zakat is seen as a method for the redistribution of income and wealth among a society. It is one of the important bases for Islamic fiscal policy and for establishing social justice.
   o Zakat spread the spirit of brotherhood and shows the integration and cohesiveness among Muslim society. Poor and needy do not feel that they are left out by their community. It is the duty of the community as a whole and the leadership of the community in particular to guarantee that those individuals have the necessities of life without letting them feel down or less than the other members.
- *Sadaqa* (Charity) is another mean of establishing a social justice system in Islam. It is not obligatory but strongly recommended.
- There are many types of Sadaqat but we focus only on giving materialistic items (money or goods) to the needy Muslims. When it is necessary and during emergencies and crises, the ruler of the Islamic state can take money and other items from people to alleviate the situation that Muslims face.

### 6. Prohibition of *Haraam* Transactions

- In relation to all business and financial transactions and contracts, *Shari’a* states that “All transactions, contracts and activities are permissible unless there is a clear prohibition”
- *Shari’a* prohibits using or dealing in certain commodities or activities. Only *halal* activities are allowed. Islamic economic and financial system controls the engagement of investment companies in activities that are acceptable and consistent with the *Shari’a* law thus preventing the occurrence of activities forbidden by Islam.
- Islamic financing of enterprises involved in any type of activities/commodities that is unlawful in Islam or harmful to mankind is prohibited. The Islamic Bank, for example, does not finance liquor manufacturing, transportation, storage or distribution companies.
- Therefore, Islamic economic and financial system must encourage and develop the application of Islamic *Shari’a* and principles to economic, financial, and banking transactions and business affairs.
- In order to ensure the conformity with Islamic *Shari’a*, Islamic financial institutions form *Shari’a* supervisory board which consists of *Shari’a* scholars plus other specialized experts in economics, finance, and banking who screen the suitability of investments on an ongoing basis and provide guidance on products to the Bank’s management.
7. Avoidance of Speculation or Gambling (Qimar)

- Gambling and chance based (zero-sum) games are prohibited in Islamic Shari’a because it is not based on logical and calculated reasoning. It depends on luck. Luck by itself is not a way of life in Islam. Each individual has to do its parts and take the necessary means to achieve his objective.

III. Islamic Economic System

- From Islamic view, as in other traditional civilizations, economics was never considered as a separate discipline or distinct domain of activity. Consequently, there is no word for economics in classical Arabic language. The term of “Iqtisad” (economic) being a fair recent translation of the modern term "economics" in Arabic and having a different meaning in classical Arabic where it means primarily moderation.
- An economic system is a set of ideas, institutions, and mechanisms that a society chooses to allocate its resources in production of goods and services, consumption of these goods and services, and distribution of the resulting income and wealth in a particular society.
- The definition of a 'society' in the Islamic economic writings varies from any primary Muslim nation such as Bahrain or Indonesia to nothing less than the entire community of believers, the “Ummah” which currently incorporate more than the fifth of humanity.
- Islam has provided us with a complete set of rules, regulations, and guidelines that cover all aspects of our lives including an economic system.
- The proposed Islamic economic system must be dynamic, viable, growing, balanced and compatible to Shari’a.
- The proposed Islamic economic system is based on some fundamental principles and rules derived from Shari’a that distinguishes it from other economic theories. These fundamental rules must be the same in every Islamic society. However, every Islamic society can have its different policies and
practices. Nevertheless, these rules and practices must be in compliance with \textit{Shari’aa}.

\textbullet~In addition to the main Islamic principles that have been stated in the \textit{Shari’aa} section, here we add more of the socio-economic principles that influence the Islamic economic system.

1. \textbf{The balance between spiritual and material needs}
   
   \begin{itemize}
   \item Islam emphasizes that the success of both the individual and the society depends on a balance between the spiritual and the material needs of people.
   \item The balance would result in behaviors and practices that enhance the harmony and prosperity of Muslim society.
   \item In all its practices, Muslim individuals always remember that the ultimate goal of any action is to please \textit{Allah} (swt). The individual in the Islamic society protects and promotes the interests of his fellow Muslims. Transparency and full disclosure in any transaction that involves other parties is a must in Islam. Honesty and straightforwardness in dealing with others is a norm in the Islamic Society. Therefore, members of society live in harmony and peace
   \item Growth in Islamic economic definition should not be only in tangible terms.
   \end{itemize}

2. \textbf{Promoting Social Justice and Equity (\textit{Adl})}

   \begin{itemize}
   \item A just economy is part of a just, healthy, and moral society. A just economy is a central issue of the Islamic system.
   \item The purpose of Islamic principles and rules is to make the individual member of Islamic society \textit{socially responsible}. Justice and equity are rooted deep in the Islamic economic system from the equal opportunity for all to use the natural resources in production, to justice in exchange and distribution.
   \end{itemize}

With regards to distributive justice, Islam recognizes that people are different in their mental and physical abilities and skills; and as a result their productivity and hence their incomes would not be equal.

Islam permits differences in wealth within reasonable limit, but does not tolerate these differences growing so wide that some people spend their life in luxury and comfort, while the great majority of people are left to lead a life of misery and hunger.

Thus, social justice in Islam obliges the leader of Islamic society to create and provide equal opportunities to all, and to remove any obstacles equally for every member of the society.

Furthermore, legal justice implies that all members of the society have equal status before the law. Economic justice and distributive justice as well are all based on the fundamental Islamic concept of justice and equity.

The key social justice of Islamic economy lies in man’s relationship with Allah, his universe and his people, and the nature and purpose of man’s life on earth.

3. The value of work as a mean to development

Development of our earth while preserving our environment is one of the greatest tasks of mankind. Islam is a practical religion. It is a religion of action. It considers man’s work not a right but a duty and obligation.

Work and work ethics have been mentioned in Qur’an hundreds of times. In most of the cases, it is mentioned in link with faith. Sunna, too, emphasizes the importance of work. Qur’an and Sunna highly praised man who utilizes his effort and times to work. On the other hand, Islam discourages those who do nothing for themselves or their community and just be dependent on others even if they are practicing rituals during
the day. The worker is better than the worshiper, let alone who does nothing.
- Of course, when we talk about work, we mean the good and legitimate work which benefits the individual, the society, and which is halal.
- Individual has the right to choose the type of work that fit with his skills and abilities but at the same time, it must meet the needs of the Muslim society.

4. **The economic role of the Islamic State**
- The state is an institution that undertakes the organization of social life, enforces the law and security, defends the country from any foreign aggregation, plans and implement polices to achieve development and prosperity, and above all protect and propagate the Islamic faith without forcing it on others.
- The state's main role is to prevent violation of the principles, rules and regulations, and to provide the necessities and the infrastructure necessary to facilitate the economic activities, and to ensure that justice prevails in all walks of social life.
- Guarantee of individual’s freedom and equal opportunity in term of access to and use of resources is another duty of the state.
- In dealing with economic realities, Islamic state must give priority to develop the sectors that contribute most to the benefit of the society, work to achieve consistent and stable economic growth, constant price level, and manageable unemployment.
- The legitimacy of the state is derived from its enforcement of *Shari’a* rules and principles.

5. **Wealth is a mean not an objective by itself**
- Islam encourages man to utilize all available resources to gain more wealth in order to use it for the enhancement of personal objectives and development of the society as a whole.
o On the other hand, it is highly undesirable for Muslim to live in poverty if he can improve his standards of living.

o Wealth is only a means for the achievement of man’s ultimate objective and not an end by itself. It must be earned through productive, beneficial, and halal way.

o Wealth owner is a trustee who holds this wealth as a trust on behalf of Allah (swt). He must pay its Zakat and participate in charitable and productive activities of the society. He must not use his wealth in anyway to harm society or self.

6. The balanced relationship between Individual and society

o Personal interests as well as the welfare of the whole society are protected and fulfilled in Islam.

o Self interest and private gains of the individual are not denied, but they are regulated so that they don’t contradict with the interest of the Muslim society as a whole

7. Economic freedom within a defined limit

o Islamic economy gives individuals, at the economic level, the freedom to offer and buy productive resources, and to produce and exchange goods and services. This freedom is bounded by the spiritual and moral values in which Islam believes. It forbids a group of social and economic activities, such as riba, monopoly, gharar and the like, which hinder the realization of the principles and values adopted by Islam.

o With reference to Islamic principles, the forces of supply and demand have been well recognized on market. People are left free to transact and exchange goods and services.

o The state can only intervene if a Dhulm (transgression) is unlawfully committed against one party, or some forbidden transactions are executed. Other's properties must be treated in a fair and just way.
8. **Cooperation vs. Competition**
   - Islam considers both cooperation and competition as parts of human nature. Cooperation and brotherhood, however, is an integral part of the Muslim society. Competition for more rewards from *Allah* and for righteousness and good deeds is encouraged in Islam. Competition is also allowed in a Muslim community in the economic activity.
   - Islamic teaching emphasizes that cooperation and competition must be conducted in probity and piety rather than in evil and enmity.

9. **Parallel forms of ownership;**
   - From Islamic viewpoint, ownership is accepted in a variety of forms—instead of the principle of only one kind of ownership. Private ownership, public ownership and state ownership are three parallel forms in Islamic law.
   - Real ownership belongs to *Allah*. People holds property in trust for which he is accountable to *Allah*, in accordance with rules clearly laid down in the *Shari‘a*.
   - The respective scopes of the three kind of ownership are not rigidly defined, but left to be determined in the light of certain principles, depending on the needs and circumstances.

10. **Property protection, rights, and obligations**
    - Islam emphasizes the concept that *Allah* (swt) is the ultimate owner of all property.
    - Man has given the right to own property in order to be able to perform his duties and obligations in this life.
    - Property ownership in Islam comes through individual’s efforts and time spent on work or through transfer of property from one person to another via sale, gifts, grants or inheritance.
    - The obligations of the property owner are to pay their *Zakat* if it is due, not to use the property in anyway that contradict with *Shari‘a* or harm
the society, or to misuse the property in a way that lead to a waste or destruction of the Islamic society’s resources. The property owner must not take advantage of his ownership at the expense of the society.

- The respect of property rights and private ownership in Islam is so strong that if one gets killed while defending one's belongings that have been acquired by legitimate means he/she attains the status of a martyr.

11. **Fulfillment of contacts and obligations on time**

- Muslims are always required to honor their contracts. The most important contract to be fulfilled is the one of Ibadah and Istikhlaf on this earth between \(\text{Allah (swt)}\) and man.
- Islam encourages parties to document and write their contracts at the presence of witnesses to ensure that parties have full understanding and clear any ambiguity.
- Muslims are ordered to abide by the terms of contracts that they have entered into.
- Faithfulness (Amana) to contractual obligations is a corner stone in the Islamic economic transactions.

12. **The Concept of Al-Baraka (felicity, benediction)**

- The concept of Baraka serves as material inducement for the individual to follow the path of proper conduct. Baraka is a fact of life for true believers. It cannot be quantified but definitely can be felt and experienced.

13. **The Concept of Qana’u (Contentment)**

- The main goal of the Muslim economic agent is not to maximize its materialistic benefits (maximizing economic profit, maximizing utility function) but to seek \(\text{Allah’s }\) pleasure, forgiveness and blessings. Thus, Muslim will not attempt to maximize his benefit at the expense of harming other individual, society, or the environment. Muslim economic
agent would work in the most efficient way because working efficiently is par of his faith but the Rizq (wealth and possessions) is in the hands of Allah and it is already determined for every one.

The Behavior of Muslim Producer and Muslim Consumer

- The Muslim Producer
  - The Muslim is free to produce efficiently and to trade for personal profit. However, in exercising this freedom he is required to avoid causing harm to others. He must also avoid earning more than his efforts justifies. Profit must be earned using fair and legitimate means. This means he must pay 'fair' wages, charge 'reasonable' prices and be content with 'normal' profits.
  - All relevant information pertaining to a transaction must be disclosed.
  - Muslim producer must not engage in speculation and monopolization, or make deals that involve gambling, uncertainty and exploitation.

- The Muslim Consumer
  - The Muslim consumer must not devote resources to activities or commodities, which are deemed illegitimate.
  - He is required to show moderation in consumption which may lead to the elimination of scarcity problem through a lowering of aggregate demand and prevention of demand-pull inflation.
  - The Muslim must make voluntary donations to less fortunate members of the Islamic community.
IV. Islamic Financial System

✧ Islamic financial system broadly refers to financial institutions operations and services, and Islamic market transactions that comply with Islamic principles, rules and codes of conduct. Islamic financial system is not only the prohibition of *riba* or avoidance of *gharar*; it is much more than that. It is the adoption of the entire Islamic values, principles, and practices, which maintain and dispense justice and equity, and promote development and welfare to all.

✧ Islamic finance is guided by the entire principles that govern Islamic *Shari’a* and Islamic economic system. Islamic finance is more than financial contracts.

✧ Islamic financial institutions have an important role to play in the light of Islamic teachings in order to please *Allah* (swt). They must operate within the framework of the *Shari’a*, based on *Qur’an* and *Sunna*. Their activity, transactions and behavior must be in line with these principles.

✧ One of the important fundamentals of Islamic financial institutions is to promote goodness, justice and equity. They play the role of intermediaries between those who have the surplus of funds and those who have shortage of it. They provide alternative methods to raise funds.

✧ Besides the principles and rules discussed in parts (II) and (III) such as *riba* (interest), *gharar* and *maisir* (contractual uncertainty and gambling), and *haram* industries (prohibited industries such as those related to pork products, pornography, or alcoholic beverages), we can observe other basic principles that distinguish Islamic financial institutions from conventional ones, which can be summarized as follow:

1. **Business Framework**
   - While the conventional financial system is based only on man-made laws and no religious laws or guidelines, Islamic financial system is based on *Shari’a* rules and principles. *Shari’a* scholars ensure adherence to Islamic laws and provide guidance.
o The direct result is that the Islamic financial institution and its staff must behave and act within the framework of Islamic teachings in its broadest sense.

o Clients of an Islamic financial institution should have the feeling that they are entering not only a distinguished place in the types and quality of products but also in the way they are treated— with care, respect and the eagerness to help as a way of pleasing Allah (swt).

2. Contractual Relationship

o While contractual relationship has only one form in the conventional financial institution, which is only a creditor-debtor relationship, contractual relationship in Islamic financial institution depends upon the nature of transaction. It could be a seller-buyer relationship (Murabaha), a lessor-lessee relationship (Ijara), a partnership (Musharaka), or a creditor-debtor relationship (Qard Hasan).

3. Participation and Risk-Sharing Partnership

o One of the major principles of Islamic finance is partnership and risk sharing.

o Islamic financial institutions offer their clients participation in risk sharing mode of financing rather than fixed interest on deposits. The notion of a risk free reward or return is not acceptable in Islamic finance. Profit is justified on the basis of sharing the responsibility of either profit or loss. This is called the principle of liability.

o Any risk-bearing instruments reflecting a real asset and earning a variable rate of return tied to the performance of the asset is considered consistent with Islamic Shari’ a. Money does not create money by itself. Contribution to partnership may be by money and efforts or by one of them.

o Management of the enterprise can be in one of several forms depending on whether the financing is through Mudharaba, Musharaka, etc.
o The relation of investors to the Islamic institution is that of partners whereas that of conventional banking is that of creditor-investor.

o The Islamic financial system is equity-based whereas the conventional banking system is loan-based.

4. Contribution to the socio-economic goals of the Islamic society

o The Islamic financial system should contribute to achieving the major socio-economic goals of the Islamic society.

o While conventional finance focuses solely on economic transactions and markets, Islamic financial system stresses the ethical, social and moral dimensions of wealth creation that enhance equality and fairness for the society as a whole.

o Islamic financial institution is socially responsible towards the poor, and needy in the Islamic society, and must contribute in the efforts of poverty alleviation and people empowerment through creating social funds for poor and needy, and providing education scholarships to students.

o The Islamic bank is required to remind his customers of Zakat payments on the clients’ assets which have not been used throughout the period of one year.

5. Accounting and Auditing Standards

o While conventional financial institution follows the accounting standards of the International Accounting Standards, American Financial accounting Standards, and British Accounting Practices, the rapid expansion of the Islamic financial industry that started in the 1970s was not initially accompanied by the creation of a set of internationally recognized accounting rules.

o Islamic institutions around the globe, therefore, had to resort to developing their own accounting solutions for their new products,
making comparisons across institutions difficult, and sometimes even giving the impression of lack of transparency.

- The need for a body of accounting standards purposely designed to reflect the specificities of Islamic products became even more pressing as new and more complex instruments were being marketed.

- To close this widening gap, the AAOIFI was created in 1990 to design and disseminate accounting and auditing standards that can be applied internationally by all Islamic institutions.

- The AAOIFI also plays a crucial role in pursuing the harmonization of Shariah-based rulings across Muslim countries.

- The pursuit of international consistency not only eases the task of supervising internationally active institutions, but it would also ultimately favor the regulated institutions, as Islamic transactions would become better understood, and thus more attractive for Muslim and non-Muslim investors across the world. In addition, it would foster the integration of Islamic institutions into the international financial community.

6. **Balance Sheet**

- An Islamic financial institution serving as intermediary may act as partner or as a provider of services in profit-making ventures.

- Because of the joint participation among an Islamic financial Institution, shareholders and depositors in equity investment, the structure of the balance sheet of an Islamic financial Institution differs from that of a standards conventional depository institution because the equity capital base of Islamic financial institution may be larger than that of a conventional depository institution.

- The balance sheet of Islamic Banks will not show the interest earning assets and Interest bearing liabilities.

- Also, the balance sheet of the Islamic banks will be more detailed than of the conventional banks such as will include: Investments in Murabaha,
Mudharaba, Musharaka, Salam, Istina’a…etc. versus Loans and Advances.

7. *Shari’a Supervisory Board (SSB)*

- To make sure that Islamic financial institutions are in compliance with *Shari’a*, it has become a common practice for these institutions to appoint their own board of *Shari’a* scholars.
- Therefore, the first measure that an institution is in compliant with *Shari’a* is to appoint a *Shari’a* Supervisory Board (SSB) or *Shari’a* Supervisory Committee (SSC).
- This Board is generally comprised of three or more of scholars who are well versed in Islamic jurisprudence. There is no existence of such Board in the conventional bank which aiming to attain profit without considering *Shari’a* precepts.
- SSB helps minimize *Shari’a* risk—the risk that the terms agreed in a contract do not effectively comply with Islamic rules and principles and thus are not valid under Islamic law.
- Financial regulators should also appoint their own *Shari’a* experts, which provide advice on the instruments and services offered by the institutions in their jurisdiction. Consultation with these experts would be crucial to ascertain whether the regulations issued by the SSB with regard to Islamic institutions, as well as the licensing of different activities, are compatible with Islamic principles.
- Regulators should inform the public of what types of Islamic institutions and products will be supervised. They should also require institutions offering Islamic products to actively pursue transparent behavior. For instance, commercial banks should inform investment (*mudharaba*) depositors of the profit-and-loss nature of their deposits.