

**SHARI‘AH COMPLIANCE OF FOREIGN EXCHANGE TRANSACTIONS  
IN THE ISLAMIC BANKING INSTITUTIONS**

**MOHIDIN YAHYA HJ SHAMSUDIN**

**UNIVERSITI TEKNOLOGI MALAYSIA**

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THE ISLAMIC BANKING INSTITUTIONS

MOHIDIN YAHYA HJ SHAMSUDIN

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## **DEDICATION**

In dedication to my mother Misratin Hj Ismail who nurtured me into who I am, my wife Raihana Hj Rashdi for her affection and understanding, my children Muhaina, Khushairy, Sabrina and Farhana my grandchildren Aisyah Humaira, Adib Aysar and Idzaara Elayna for their love and support all the way through. You are truly inspirational.

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## ABSTRACT

The subject of foreign exchange transactions in the Islamic banking institutions with particular focus on *shari'ah* compliance is the central theme of this research. The issue of *shari'ah* compliance has always been at the forefront of the Islamic banking and finance intellectual and academic discourses. Basically, the conducts of foreign exchange transactions in the conventional as well as the Islamic banking institutions are ostensibly similar. The issue is therefore, what differentiate between these two Forex transactions? That Islamic Forex differs from the conventional Forex and does not contravene the Islamic laws. This study sought to ascertain the permissibility of foreign exchange transactions from the perspective of *shari'ah*. Next the study examines differences in foreign exchange rulings in the Malaysian Islamic banking against the *fatwa* issued by other jurisdictions; the extent to which uniformity or differences of *fatwa* issued by different jurisdictions in Malaysia and the Gulf Cooperation Council countries. The study also aims to reconcile the differences and reach a common understanding to standardise methods of foreign exchange transactions in the Islamic banking institutions. This is to ensure that the Islamic rules on foreign exchange transactions can be institutionalised to become a system that is universal, acceptable and able to meet the needs of the industry players. Employing the methodology used by the International *Shari'ah* Research Academy (ISRA), the Islamic principles related to Forex trading are examined to determine their sources and evidences and then the *fatwa* from various jurisdictions are compared to ascertain their similarities and differences. The study found that the *shari'ah* principle unanimously accepted by all jurisdictions is *Bai' al-Sarf*, while other *shari'ah* principles related to *Waád* and *Tawarruq* are to facilitate the execution of *Bai' al-Sarf* at the end of the respective transactions. The study has contributed to the Islamic banking literature, particularly on the subject of foreign exchange transactions; that foreign exchange transactions as practiced by the Islamic banking institutions in Malaysia and other countries are legitimate transactions from the perspective of *shari'ah*. The fact that a truly independent and competent Islamic financial system is needed makes the standardisation of procedures and the establishment of an independent legal framework for Islamic foreign exchange necessary and timely.

## ABSTRAK

Subjek urusan pertukaran asing dalam institusi perbankan Islam dengan tumpuan khusus kepada pematuhan syariah merupakan tema utama kajian ini. Isu patuh syariah sering menjadi topik perbincangan dalam wacana akademik dan intelektual dalam bidang kewangan dan perbankan Islam. Pada asasnya, tata urus pertukaran asing dalam perbankan konvensional dan institusi perbankan Islam tampak serupa. Urusan pertukaran asing dalam perbankan Islam adalah berbeza daripada urusan pertukaran asing konvensional dan ia tidak bercanggah dengan undang-undang Islam. Kajian ini bertujuan menentukan keharusan urusan pertukaran asing dari perspektif syariah. Seterusnya, kajian ini meneliti perbezaan fatwa bagi urusan pertukaran asing dalam perbankan Islam di Malaysia berbanding fatwa yang dikeluarkan oleh negara-negara lain; mengukur tahap keseragaman fatwa yang dikeluarkan pihak berkuasa di Malaysia berbanding negara-negara Majlis Kerjasama Teluk (GCC). Kajian ini juga bertujuan mengharmonikan sebarang perbezaan bagi menyeragamkan kaedah urusan pertukaran asing supaya tata cara Islam dalam transaksi pertukaran asing boleh diinstitusikan untuk menjadi satu sistem yang universal, boleh digunapakai, dan memenuhi keperluan pelaku industri. Menggunakan kaedah analisis perbandingan fatwa yang digunakan oleh Akademi Penyelidikan Syariah Antarabangsa (ISRA), penyelidik meneliti prinsip-prinsip Islam yang berkaitan dengan urusan pertukaran asing untuk menentukan sumber dan bukti yang ada. Setelah itu fatwa daripada berbagai pihak berkuasa dibandingkan bagi menentukan persamaan dan perbezaan yang wujud. Kajian mendapati bahawa prinsip syariah yang diterima sebulat suara oleh pihak berautoriti dalam bidang kewangan Islam di Malaysia dan Negara-Negara Teluk ialah Bai' al-Sarf, manakala prinsip syariah yang berkaitan dengan Wa'ad dan Tawarruq adalah untuk memudahkan pelaksanaan Bai' al-Sarf pada tempoh akhir urusan berkenaan. Kajian ini telah menyumbang kepada penulisan berkaitan perbankan Islam, terutamanya mengenai subjek urusan pertukaran asing; bahawa urusan pertukaran asing seperti yang diamalkan oleh institusi perbankan Islam di Malaysia dan negara-negara lain adalah urusan yang sah menurut perspektif syariah. Sebuah sistem kewangan Islam yang bebas dan berwibawa memang sangat dikehendaki. Justeru, penyeragaman prosedur dan penubuhan rangka kerja perundangan yang bebas untuk urusan pertukaran asing dalam perbankan Islam adalah amat perlu dan tepat pada masanya.

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**LIST OF ABBREVIATIONS**

AAOIFI	-	Accounting and Auditing Organisation of Islamic Financial Institutions
AGM	-	Annual General Meeting
BAFIA	-	Banking and Financial Institution Act 1983
BBA	-	<i>Al-Bai' Bithaman Ajil</i> (Deferred Payment Sale)
BIMB	-	Bank Islam Malaysia Berhad.
BIS	-	Bank of International Settlement
BMI	-	Bank Mua'malat Indonesia
BMMB	-	Bank Mua'malat Malaysia Bhd
BNM	-	Bank Negara Malaysia (The Central Bank of Malaysia)
BOP	-	Balance of Payment
CBA	-	Central Bank Act 2009
CBB	-	Central Bank of Bahrain
CBK	-	Central Bank of Kuwait
DFIA	-	Development Financial Institutions Act 2002
ECB	-	European Central Bank
FDI	-	Foreign Direct Investments
FOMC	-	Federal Open Market Committee
FTSE	-	Financial Time Stock Exchange
GBP	-	Great Britain Pound

GCC	-	Gulf Cooperation Council
GDP	-	Gross Domestic Product
IBA	-	Islamic Banking Act
IBBL	-	Islamic Bank Bangladesh Ltd
IFIs	-	Islamic Financial Institutions
IFSB	-	Islamic Financial Service Board
IPRS	-	Islamic Profit Rate Swap
ISF	-	Islamic Financial Business Model
ISRA	-	International <i>Shari'ah</i> Research Academy
JIB	-	Jordan Islamic Bank
KLIBOR	-	Kuala Lumpur Inter Bank Offered Rate
KLSE	-	Kuala Lumpur Stock Exchange
KLSI	-	Kuala Lumpur <i>Shari'ah</i> Index
MNC	-	Multi National Corporations
LOP	-	Law of One Price
MNE	-	Multi National Enterprise
MYR	-	Ringgit Malaysia
NE	-	National Enterprise
OIS	-	Overnight Index Swap
PPP	-	Purchasing Power Parity
QFC	-	Qatar Financial Centre
QFMT	-	Qatar Financial Market Authority
RMB	-	Currency of the People Republic of China
SAC	-	<i>Shari'ah</i> Advisory Council

SAMA	-	Saudi Arabia Monetary Authority
SAW	-	Salallahu Alaihi Wassalam (Peace be Upon Him)
SC	-	Securities Commission
SGF	-	<i>Shari'ah</i> Governance Frameworks
SPTF	-	Skim Perbankan Tanpa Faedah (Interest Free Banking)
SWT	-	Subhanahu Wa Ta'ala
USD	-	United State Dollar



## CHAPTER 1

### INTRODUCTION

#### 1.1 Overview

The proposed study attempts to explore and investigate the practice of Foreign Exchange transactions in the Malaysian Islamic banking institutions. To what extent, the practice of foreign exchange transactions in these institutions is consistent and in compliance with the principle of in regard to business transactions. The study intends to focus its investigation on the element of *Riba* which is the most stringent injunction in the Islamic business practices in order to determine the permissibility of the transactions. Indeed, *Riba* is central upon all Islamic commercial transactions which had been unanimously accepted by all Schools of Islamic Jurisprudence that *Riba* must be avoided at all cost, in all its forms and practices. However, in addition to *Riba*, this research will also delve into other *shari'ah* injunctions such as uncertainty or *Gharar* and speculation, gambling or *Maysir*. This is to ensure that all elements that affect the validity of Islamic foreign exchange transactions from the perspective of *shari'ah* are given due emphasis so that a balance approach in determining the compliance of the practice to the rule of *shari'ah* can be achieved. The study focuses on both the traditional as well as contemporary scholars on Islamic banking and finance to investigate the salient feature of foreign exchange practices in Islamic banking and to discover evidences from the Islamic jurisprudence on the methodology of the practice. The objective is

to determine that the Islamic banking operations relating to foreign exchange transactions are indeed in full compliance to the rule of *shari'ah*.

## 1.2 Background of the Study

The financial system in Malaysia is unique in the sense that it has two systems running parallel to each other. On the one hand, there is the conventional system that has existed since the British colonial era when they set up a branch of English banking system in Penang and Singapore whose function is mainly to facilitate repatriation of revenue to England. The conventional system has been well accepted by the people of Malaya and then Malaysia especially the non-Muslims. The system however, is not well received by predominantly the Muslim population of the country. The Muslims are aware that the conventional system is *Riba* based and it is therefore, unacceptable to the law of *shari'ah* and as Muslim they realised that having a system that is *shari'ah* compliance is a necessity in order to enable them to participate actively in it without fear of contravening the rule of *shari'ah*. The Islamic system of finance on the other hand was first introduced to Malaysia in the eighties and since then, the financial landscape of this country is completely overhauled.

The development of the modern Islamic banking system began since the establishment of Mit Ghamr Local Savings Bank of Egypt in 1963 which has become a remarkable milestone for the industry. The boom period of Islamic banking system was between the 1970s and 1980s as many Islamic banks gained footing in the predominantly Muslim countries. As in 2011, there were 150 interest-free financial institutions commenced operations in both Muslim and non-Muslim countries where these institutions serve banking services just like the interest based banking institutions covering areas of insurance, pawn broking, and stock market transactions (Haron & Ahmad, 2000). The Islamic banking system in Malaysia was preceded by the establishment of Lembaga Tabung Haji; a saving institution that was specially set up in the sixties to cater for the Muslim who want to save for financing their passage

to perform Haj in the Holy land of Mecca. Then in 1983 Bank Islam Malaysia Berhad was set up and operates in tandem with the more established conventional banking system and since then the financial landscape of Malaysia was permanently changed. Malaysia's Islamic financial system offers comprehensive arrays of services within the world of Islamic economic. In addition to providing retail banking services and products, the Malaysian Islamic banks are also providing access to Islamic insurance and pawn broking. Islamic finance is labeled as a niche market and unique because they offer products and services that are in compliance with the principles of *shari'ah*. This feature may have first isolated them from the conventional financial institutions but due to the increasing demands and intense responses for an alternative financial system, the Islamic finance progresses to fulfil the more urgent and growing needs of the population. The positive response and acceptance to the new Islamic banking system has triggered both western and Islamic economists to develop and create new products that have linkage to Islamic finance and to impact its underutilized capital pool to the global finance system (Haron & Ahmad, 2000).

For over the past two decades, the Islamic banking has undergone rapid growth in both aspects of volume and numbers; it has emerged as an alternative to interest-based banking institutions and has taken roots in both Muslim and non-Muslim countries. Islamic banking operates in more than sixty countries mostly in West Asia and South East Asia. The entire banking system of Iran, Pakistan and Sudan was completely transformed and converted to Islamic banking. Countries outside of the Islamic world, such as, Denmark, Luxembourg, and China provide the Islamic banking facilities as alternatives to their existing banking and finance system. In Britain, London is the central activity upon the establishment of the Institute of Islamic Banking and Insurance whose role is to disseminate information about Islamic finance. In the Muslim countries where the existing conventional banking institutions dominate the banking system; the Islamic banking recorded the fastest growth especially within the credit market segment. In Malaysia, the Government support for the development of Islamic banking and finance was the catalyst for its remarkable expansion. Support in the form of Legislation such Islamic Banking Act 1983 and Government Investment Act 1983 was the first initiatives by the Government of Malaysia that trigger a development towards a comprehensive

Islamic financial system (Haron & Ahmad, 2000). In 1993 the Ministry of Finance introduced an 'Interest-Free Banking Scheme' (Skim Perbankan Tanpa Faedah SPTF) marked the emergence of a truly Islamic banking system where more and more participants were drafted into the system via the BNM policy of allowing conventional banking to offer an Islamic Window that cater for client who wish to participate in the Islamic banking system. The Islamic Window was replaced by the Islamic subsidiaries whereby those conventional banking who wish to offer Islamic banking must have a separate license to operate as a full pledge of Islamic banking.

In addition to being the pioneer of the Malaysian Islamic financial system, the Central Bank of Malaysia, Bank Negara Malaysia (BNM) also is the pioneer of the Islamic interbank money market system. The nation owns the full-fledged Islamic banking system that runs in tandem with the western-style conventional banking system, and is recognised as the pioneer of the Islamic banking research and development amongst Muslim countries. In 1993, the BNM approved a total of 21 Islamic financial products for domestic financial institutions; the wide array of financial products accompanied with heavy volumes of participants, along the progressive development of the Islamic interbank system all induced the commence of a full Islamic secondary market at the same time allocated the prerequisites for the viability of a domestic Islamic financial system. According to the BNM Annual Report (1999), the Islamic interbank money market has recorded volumes increment from MYR158 billion to MYR436 billion from 1998 to 1999. BNM has also implemented numerous measures in order to accelerate the growth of Islamic banking sector. The GP8, a new financial disclosure model form, introduced in 1996, devoted to inculcate transparency upon disclosure for Islamic banking operations (Haron & Ahmad, 2000). Thereafter, BNM set ups of full-fledged Islamic banking branches and the *Shari'ah* Advisory Council (SAC) whose main objectives are to oversee the operations of Islamic banking and to resolve issues pertaining to Islamic banking and finance through issuance of *fatwas*. The liberalisation of the industry in 1993, over 50 financial institutions including commercial banks, finance companies, merchant banks, cooperative banks and discount houses offer Islamic banking services under the Interest-Free Banking Scheme (SPTF). During the 1997 Asian financial crisis, the Islamic banking system around the globe was adversely affected however, Malaysia's rapid and vigorous economic recovery has made possible for

spillover effect. The proof of the recovery was recorded by the increase in total assets of the Islamic banking sector from MYR21.6 billion to MYR35.7 billion by the end of 1999 that was a pertinent growth of 65.3%. In addition, BNM Annual Report (1999) reported total deposits mobilised was at a stable growth rate of 50.6% (Haron & Ahmad, 2000). After laps of almost ten years since the establishment of BIMB, the Government launched the second Islamic bank: Bank Mua'malat Malaysia Berhad (BMMB) which was a merger between Bank Bumiputra Malaysia Berhad and Bank of Commerce Malaysia Berhad, commenced operation on October 1<sup>st</sup>, 1999 (Haron & Ahmad, 2000).

Although Islamic banking is a fairly recent phenomenon in the Malaysian financial system but it has been regarded as a viable and sustainable alternative system with growing demand for its services both amongst Muslim and non-Muslim population. The emergence of Islamic banking in Malaysia in 1983 witnessed the development of banking activities that complies with the principle of *shari'ah* including foreign exchange transactions. Indeed, the establishment of Bank Islam Malaysia Bhd., 30 years ago, has catapulted the development of Islamic Mua'malat in Malaysia, introducing transactions that were previously beyond the reach of Muslim mainly due to its non-conformity with the Islamic principles of Mua'malat. The quest for excellent and comprehensive services has led to the Islamic banking in Malaysia, striving for innovation to establish and offer new instruments and services encompassing the entire spectrum of banking facilities and services. Since the operational commencement of Bank Islam Malaysia Bhd, foreign exchange transaction has become one of the significant activities in the operation of Islamic banking institutions in terms of services and profits contribution to the bank.

While study on Islamic banking products and services has been extensively undertaken by various contemporary scholars focusing primarily on the methodology and legitimacy of such transactions, however subject on foreign exchange transactions has not been given priority in the study of the Islamic banking and finance. There seems to be some misguided notion about foreign exchange operations amongst the Islamic bankers that Forex operations are complex and technical in nature though it seems fascinating. The conventional Forex transactions always involves element of speculation and uncertainty but if it is closely and

prudently supervised it can be the most effective means of protecting the bank against the unwanted exposures. On the contrary, Forex instruments can also bring down the strongest banking institution in the world if it is abused. The Forex products are considered hybrid money market instruments that not many people could thoroughly understand them. Therefore, the need to investigate the validity of foreign exchange transactions from the perspective of *shari'ah* is imminent because it is relatively a new development and many areas of these transactions are still shrouded with ambiguity and in need of refinement in terms of many aspects of its operations.

At the onset, foreign exchange transactions in Islamic banking institutions as well as in the conventional banks are founded on similar principles; buying and selling of foreign currencies. However, the Islamic *Mua'malat* emphasises not only trade supporting the underlying transactions that makes it legitimate, but the fundamentals and conduct of such activities must also be in compliance with *shari'ah* injunction, only then the transaction can be regarded as halal. The fundamental injunction on Islamic *Mua'malat* including foreign exchange transactions is the elimination of *Riba*. The element of *Riba* which is central in the conventional banking including foreign exchange operations, warrant an in-depth study to ascertain that the Islamic foreign exchange transactions are not premised on the same philosophy as in the conventional practices and therefore is legitimate from the perspective of *shari'ah*. In addition, Islam emphasises that in conducting business transaction, elements of uncertainty, excessive speculations and gambling should also be avoided at all costs, so that Islamic *Mua'malat* can be construed as a just and equitable business undertaking.

### **1.3 Problem Statement**

The foundation of the Islamic *Mua'malat*, concerns about conformity to the *shari'ah* principles governing business transactions. The conventional financial

system focuses their operations primarily on the aspect of economic and financial matters but the Islamic system places equal emphasis on economic and financial aspects as well as the ethical, moral and religious aspects of its operations. Whilst Islam provides its followers basic freedom to enter into transactions, to negotiate and to execute contracts, this freedom however, is restricted by the injunctions on *Riba* which is considered as the single most important injunction on all business transactions (El-Gamal, 2000). *Al-Quran* declares that *Riba* is prohibited due to its exploitative nature and an inequitable distribution of wealth but Islam recognises that trades are legitimate transactions and therefore, are permitted and lawful. It is evidence that *Riba* is the central *shari'ah* issue in the Islamic finance operations and therefore, all forms of transactions and dealing including foreign exchange transaction in the Islamic banking must be free from the elements of *Riba*.

The modus operandi of foreign exchange transactions in the Islamic banking is strikingly similar to what is done in the conventional banking: 1) commodity in trade is foreign currency 2) products traded are; spot, forward, swap and option; 3) the mode of operations are similar and that the fundamental elements of foreign exchange transactions affect both the conventional and the Islamic Foreign exchange transactions. The issue is therefore, what distinguishes the two types of transactions; the conventional and Islamic foreign exchange transactions, that the Islamic Forex trading differs from what is done in the conventional system; their Forex operations are *shari'ah* compliant on the ground that they are devoid of *Riba*, *Gharar* or *Maysir*. The major misconception often associated with Islamic finance products and services is whether the products are *shari'ah* compliant or do they exist merely in names replicating the conventional banking with little changes in its form and substance? As in other products and services, the issue of compliance is central in the analysis of foreign exchange operations in the Islamic banking institutions because as it is evidently clear in the conventional system, that Forex trading always involve the element of *Riba*, *Gharar* or *Maysir* which are against the tenets of Islam.

The different understanding on the permissibility of foreign exchange products as determined by *fatwa* authorities in various Islamic countries has led to a rather low level of understanding and even confusion to many people with regard to

the foreign exchange practices in the Islamic banking (Haron and Wan Azmi, 2009). A clear knowledge on the methodology and operation of Islamic foreign exchange activities is therefore, critical because it can help bankers as well as laymen to understand the issue surrounding the permissibility of Islamic banking products concern with the compliance of these products and services to the rule and dictate of the *shari'ah* and that based on the Islamic principles employed in the trading of foreign exchange products are manifestly in compliance to the rule of *shari'ah* and therefore, it is permissible and halal. What is required is that this contradiction needs to be thoroughly investigated because any unresolved issue in the Islamic banking and finance including foreign exchange transactions may lead to a far-reaching consequence towards the development of Islamic banking in general and in the foreign exchange transactions in particular. Finding an appropriate solution to this contradiction will improve the understanding amongst clients of Islamic banking and helps avoid undermining the validity of the Islamic principles of trading in the foreign exchange transactions.

When Bank Islam Malaysia Bhd, commenced its operation in 1983, it is quite obvious that not many people are fully cognisance with the Islamic banking paradigms even amongst Muslim populations of the country especially in regard to the operations of foreign exchange; whether these transactions are in compliance to the rule of *shari'ah*. However, due to its close connection with Lembaga Tabung Haji, it is inevitable for the Bank to provide foreign exchange services as funds collected from the would-be pilgrims needs to be invested in avenues acceptable in Islam which was then not available in the Kuala Lumpur Interbank Money Market. The absence of such an investment avenue which is *shari'ah* compliance in the local money market compelled the Bank to turn its focus into the international market and deal in the Forex market to satisfy its investment requirements. This dilemma is inevitable as foreign exchange transactions is amongst the earliest products offered by the Bank to its clients. The ambiguity and uncertainty in regard to the issue of compliance of foreign exchange transactions in the Islamic banking institutions has given rise to research problems.

Frequent issues encountered in the study of the Islamic foreign exchange transactions in the Islamic banking institutions: 1) are the Islamic foreign exchange



transactions comply with *shari'ah*; 2) why are there differences in fatwa between Malaysia and the GCC countries on the same subject matter and 3) is there solution that would be able to narrow the gap between jurisdictions which would help the establishment of unified rulings on the same subject matter between different jurisdictions in both the Regions?

#### **1.4 Objectives of Study**

This study aims at ascertaining that foreign exchange transactions in the Islamic banking institutions are in compliance with the law of *shari'ah*; that they are devoid of *Riba*, *Gharar* and *Maysir*. Furthermore, they are not undertaken based on speculation, or game of chance with the intention to deceive. More Specifically the objectives of this research are;

- 1.4.1 To analyse evidence and justifications from the primary and secondary sources of *shari'ah* as well as the opinion of both classical and contemporary jurists in regard to the compliance of foreign exchange transactions in the Islamic banking institutions.
- 1.4.2 To evaluate the practice of Islamic banking institutions in undertaking the foreign exchange transactions and how the issue of compliance in the Islamic foreign exchange operations have been institutionalised within the frameworks of *shari'ah*,
- 1.4.3 To propose development of monetary instruments relating to foreign exchange transactions that can be adopted and applied by all Islamic financial institutions in both the regions and elsewhere in the world.

### 1.5 Conceptual Frameworks of the Study

The proposed study is a qualitative research specifically to investigate the permissibility and compliance of foreign exchange transactions against the law of *shari'ah*. The research is exploratory in nature based on content analysis and theory of compliance. The concept and process of the proposed study can be summarised as depicted in the following framework;

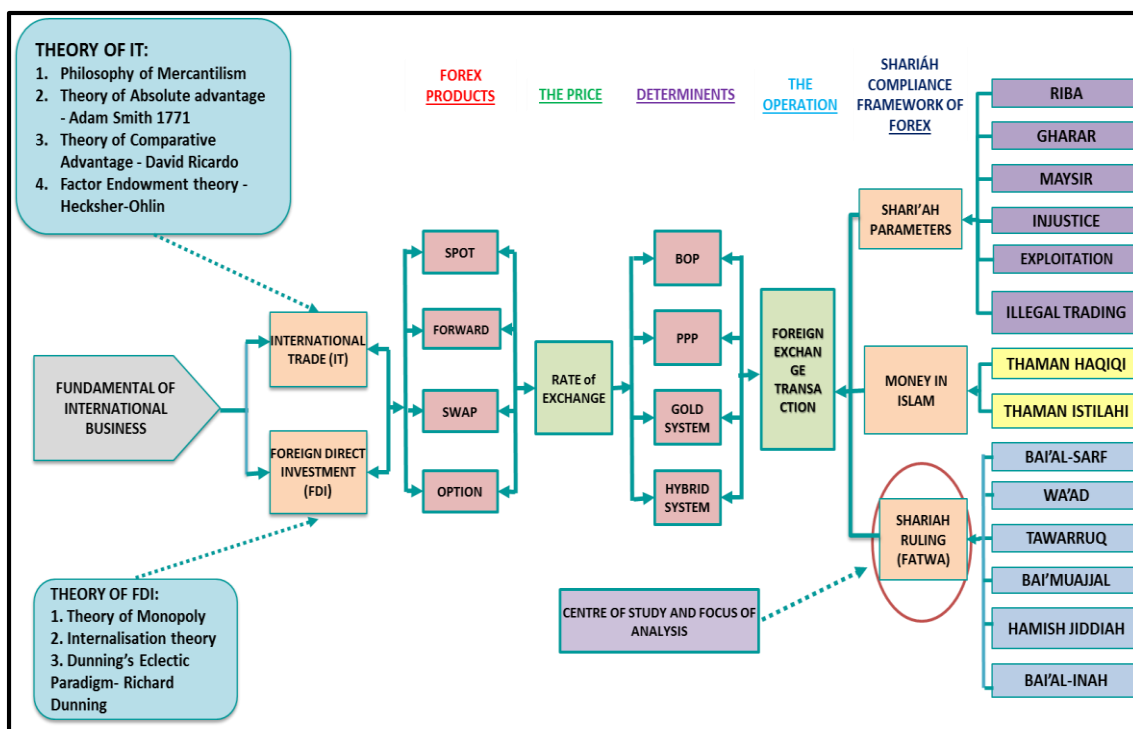


Figure 1.1 The Conceptual Framework of the Study

The study of the Islamic Foreign exchange would not be complete without looking at the conventional Forex set up. Specifically, we must look at the fundamental of foreign exchange: the international business; occurs when people from different countries undertake business beyond the national boundaries either they are doing international trades or investing funds in a foreign country. The overall impact of international business is the economic globalisation; the international integration of goods, technologies and capital reflecting the growing interconnectedness among nations and people of the world. But the immediate impact of cross-border trading is the increase in the foreign exchange transactions

among countries due to the exchange of products and services among different nationalities.

Foreign exchange transaction arises due to the internationalism of trade and the nationalism of currency; that each contracting party while dealing beyond domestic boundaries, is trying its best to use its country's legal tender as the currency of settlement which of course, would not be acceptable to the other party, compelling both parties to adopt a third currency in order to settle for the transactions, which, in the process, give rise to more foreign exchange activities whether it is spot, forward, swap or options.

Foreign exchange comprises all claims to foreign currency payable offshore, whether it is funds held or invested in foreign currency with bank abroad or bills and checks for payment of purchases again in foreign currency payable offshore. In other words, foreign exchange operations apply to banks balances denominated in foreign currency. Foreign bank notes are not foreign exchange in the narrower sense of the words; they belong to the money changing transactions; however, it can be converted into foreign exchange if these notes can be placed without restriction to the credit of an offshore account. The price of currency in the foreign exchange market is the exchange rate; the amount of currency needed to buy one unit of another currency, or the expression of value of currency put upon the currency of another country or the relative values of different currencies. The rate of exchange is influenced by the demand and supply conditions of currency and it depends on the economic conditions of a country as reflected by the Balance of Payment of a country and other determinants.

The interactions of all the aforementioned elements enable currencies to be traded in the foreign exchange market; a decentralised market for currency trading where the major players are the large international banks and financial institutions, large corporations, supported and facilitated by foreign exchange dealers; the interbank market which consist also the insurance companies and fund management corporations. The foreign exchange market is unique in the sense that it is a free

market with little supervisory entity regulating and supervising its activities, operating 24 hours daily except weekend. From the perspective of the *shari'ah*, we can look at the Islamic foreign exchange transactions from three different dimensions: 1) The Islam view of Money, 2) The *shari'ah* parameters and 3) The *shari'ah* Rulings (*fatwa*).

In the early days of Islam, gold and silver performed all the functions of cash (*thaman*). Monetary standards were made of gold and silver with a known characteristic and value. Such currency is depicted as *Thaman Haqiqi*, or *naqdain* in *Fiqh* literatures. *Thaman haqiqi* is real money represented by the precious metal; gold and silver which possess its own intrinsic value. When the economy advanced, it is impractical to carry large amount of gold for settlement of the exchange contracts. Thus, people resorted to paper money or Fiat money as a medium of exchange and gradually the role of gold as money diminished especially when the Government assumed the function as currency issuer. The position of Fiat money in both classical and contemporary jurists; that its major functions are as medium of exchange, store of value and a unit of account; having the characteristics of gold and silver, although it does not itself possess any intrinsic value like gold and silver and having the same effective cause (*Illah*) is recognised as *Thaman Istilahi* where majority of *shari'ah* scholars are of the opinion that based on the analogy of *Qiyas*, *Thaman Istilahi* as money has to be treated similar with gold and silver (*Thaman Haqiqi*), thus transactions should be undertaken based on the principle of *Bai'Al-Sarf*.

People recognised money as valuable not because it has its intrinsic value like gold and silver but due to its purchasing power, used to facilitate fulfilment of the exchange process. Money has no intrinsic utility; it cannot be utilised to directly fulfill people's needs or desire but instead it could be used to acquire goods or services. The price of money in the domestic market is Interest rate which is not recognised as such in Islam because Islam recognises money as capital only if it is invested in business or when it joins hands with other resources to undertake productive venture. In other words, money only becomes useful when applies to real asset or to be used for purchases and that money cannot be bought or sold on credit

(Ahmad and Hassan, 2009). In the context of Foreign exchange market, it is the exchange rate that is recognised as the price of money and in this context, the Islamic banking has no objection to accept such price as the legitimate benchmark for the foreign exchange transactions.

As mentioned earlier, the foundation of Islamic Mua'malat is about conformity with the rule of *shari'ah*; that the transactions undertaken are devoid of *Riba*, free from the element of uncertainty or *gharar*; do not involve speculation and the game of chance. In addition, Islam also prohibits the followers from doing illegal or unlawful trading, manipulation and exploitation in the name of trade and business. These are the other injunctions to remind Muslims that when undertaking business, they must ensure that it is done in good faith with no intention to deceive or to exploit others. All these are the parameters, the benchmark set by Islam for Muslims to achieve while undertaking business so that a just, ethical and god fearing society can be established for the benefits of the Ummah at large.

## **1.6 Significances and Original Contributions of This Study**

This study has contributed to the Islamic banking literature, particularly on the subject of foreign exchange transactions. It showcased Malaysia a remarkable achievement not only in promoting the Islamic banking as a viable alternative to the conventional system but also in developing monetary instruments commonly used in foreign exchange operations in the Islamic banking institutions which are acceptable by the *shari'ah*.

By analysing various Forex products against the Islamic business codes and conduct, the study aims to prove beyond doubt that Foreign exchange generic products are indeed in conformity with the Islamic Mua'malat with regard to the avoidance of *Riba* and other prohibitions. It follows therefore, that foreign exchange operations as practiced by the Islamic banking in Malaysia are legitimate transactions

from the perspective of *shari'ah* and therefore, it should be accepted as halal and a viable business undertaking.

The finding of this study would also shed some lights into the urgency of the authorities to further innovate and enhance the Islamic foreign exchange instruments acceptable to both Islamic as well as conventional market players. By developing monetary instruments unique to the requirements of Islam and suitable to the current market practice this can be used as an additional instrument to fight rouge traders in the foreign exchange market and in the process, helps stabilising the exchange rate of Ringgit and ultimately influence the monetary condition to the advantage of our country which is conducive to the development of our economy.

### **1.7 Research Limitation**

This study focused on foreign exchange transactions conducted by Islamic banking which are the participants of the Kuala Lumpur Foreign Exchange market. Foreign exchange through the internet will not be part of the proposed study. In addition, transactions on future commodities including currency will also be excluded from this study although it may involve some foreign exchange transactions in the process.

### **1.8 Thesis Structure and Organization**

Having elaborated the purpose and objective of the intended study and the problem statement in the introduction of this study, the remainder of this study will be organised into various chapters. Chapter 2 focuses on literature review of the research subject. It comprises of two parts; first is to highlights the foreign exchange operations from the conventional point of view, while the second part deals with the

nature of Islamic finance and specifically to highlight the foreign exchange transactions from the perspective of Islamic banking as practiced in the Malaysian Islamic banking institutions. The literature review is to provide an insight about foreign exchange transactions in both the conventional as well as the Islamic banking institutions and to help readers to understand why Islamic transaction follows much of what conventional practices espoused albeit with some adjustments.

Chapter 3 explains the methodology used in this study. Basically, it conducted a comparative analysis of *fatwa* relating to foreign exchange transactions issued by SAC of Bank Negara Malaysia and those issued by the GCC countries. The purpose is to highlight the common area of understanding and the difference between various *fatwas* on the subject matter.

Chapter 4 provides a critical analysis of the research findings especially various *fatwas* relating to foreign exchange transactions. It attempts to find a common ground for acceptance by various Islamic countries with regard to foreign exchange transactions.

Chapter 5 concludes the research; it highlights the fundamental change that needs to be instituted in the Islamic banking and finance, the way forward and the direction for future study on the subject matter in order to enhance the understanding and acceptance of practices on foreign exchange transaction in the Islamic banking in various countries.

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