

# A STUDY ON “ISLAMIC BANKING”

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## Abstract

A Bank is an institution for the safekeeping of money received from the general public, or on behalf of, its customers. Interest being the gearwheel of the recent banking, is strictly banned in Islam and that's why there can be no banking system in Islam based on Interest. Interest though apparently a productive proposition for commercial banks, several researchers believe that Interest is the main reason for Bank breakdown and Systemic Crisis. The bank failures in the U.S. during the 1980s recharged interest in equity-based offered and the disconnection of the payment of deposit from the selection activities of banks. The proposals made were prominently similar to the Islamic systems now being put into practice, at least on the deposit part. The Islamic system goes more, requiring that loans made by banks should also be equity-based. Islamic Banking has the same principal as conventional banking except that it operates in accordance with the governing rules of Shariah. This research structured with a aim to summarize in brief the theoretical structure of Islamic Banking. This research paper also bowl light on the Islamic laws and major principles regarding various mechanism and operations of Islamic Banking.

**Keywords:** Islamic Banking, Development of Islamic banking, functions, Banking without interest, etc.

## Introduction

To begin with, in Islamic finance, one must work for profits, and simply lending money to someone who needs it does not count as work. Under Islamic law, money must not be allowed to create more money. Instead, a bank must provide some service to “earn” its profits.

Islamic banking is a banking system in accordance with the *Shariat*. In Islam, money has no intrinsic value – money, therefore, cannot be sold at a profit and is permitted to be used as per *shariat* only. The Islamic Law or *Shariat* prohibits paying any fee for renting of money (called *riba*) for specific periods of time. It also prohibits any sort of investment in businesses that are considered *haraam* or against the principles of Islam. It is largely believed that these principles have been derived from the Quran and have been in practice since then.

## Objectives of the study:

1. The basic principle of Islamic Finance is prohibition of interest and usury in financial dealings.
2. Banking work without interest
3. How shariah makes Islamic bank to do business.

**Research Methodology:** The main objective of the present study is to study the Islamic banking comparing with the recent banking. The necessary data was collected from the secondary and other sources.

### **Secondary data:**

1. Available data from the reports of various committees published by the researchers, government department, relating to the banking in India and abroad.
2. Research papers/Articles on the subject of Islamic banking published abroad and in India in various journals and magazines.
3. Books, Ph.D. thesis relating to Islamic banking, published abroad and in India.

### **What is Islamic banking?**

Islamic banking is a banking system in accordance with the *Shariat*. In Islam, money has no intrinsic value – money, therefore, cannot be sold at a profit and is permitted to be used as per *shariat* only. The Islamic Law or *Shariat* prohibits paying any fee for renting of money (called *riba*) for specific periods of time. It also prohibits any sort of investment in businesses that are considered *haraam* or against the principles of Islam. It is largely believed that these principles have been derived from the Quran and have been in practice since then.

### **How did modern Islamic banking develop?**

The first successful example of an Islamic Bank was perhaps a financial institution called Tabung Haji in Malaysia which originally came into being due to high demand of interest-free money for pilgrimage (Hajj) since this was not possible by way of conventional banking system. Thus, in 1963 Tabung Haji came into being with a total of 1,281 depositors which increased to 8,67,220 depositors and with deposits over one billion Malaysian dollars. This paved the way for creation of more Islamic banks especially in Egypt where small scale Islamic Banks existed in the 1960s, catering primarily to the rural areas. The success of these banks led to the formation of the Naseer Social Bank in Cairo in the year 1972. In the same decade an International Islamic Bank for Trade and Development was proposed, which led to the creation of Islamic Development Bank with a view to promote economic development of the Muslim community in accordance with the *Shariat* laws.

### **How can banks function without taking interest?**

Islamic Banks work on the principles of an interest free banking. *Riba* or interest under Islamic Law basically means anything in “excess” – the investor should not make an “undue” profit from the hard work of the other. But it is permitted to follow a system of reasonable profit and return from investment where the investor takes a risk that is well calculated. Thus, Islamic banks make available accounts which provide profit or loss instead of interest rates. The banks use this money collected by them and invest in something that is *shariat* compliant, that is not *haraam* and does not involve high risks. Thus, businesses involving

alcohol, drugs, war weapons etc. as well as all other high risk and speculative activities are prohibited. Islamic Banking, therefore, acts as an agent by collecting the money on behalf of its customers, investing them in *shariat* compliant projects and sharing the profits or losses with them. The Dow Jones Islamic Market Index came into being in the year 1999 for investors willing to invest in *shariat* compliant projects.

There are various products in Islamic Banking that cover the needs and requirements of the consumers. Some of them are *Mudrabah* (profit sharing – one party provides finances, the other provides expertise), *Musharaka* (joint venture – both parties share everything equally), *Murabaha* (cost plus profit), *Ijara* (letting on lease), *Istisna* amongst others.

### **Banking without interest? Will it work?**

The concept of Islamic banking has often been criticized by both purists as well as modern conventional bankers. It is stated that the instruments in Islamic banking are essentially the same as the ones in traditional banking and have the same purpose with merely different terminology. It is often stated that in today's time of profit maximisation there is a thin line between *riba* and profit. The modern Islamic Banks have found ways to work around the conventional instruments and include them in Islamic banking instruments. One such example is an instrument called *mudrabah*, which is essentially nothing else but a mortgage and the banker ends up earning an interest in the form of mortgage interest rate on it. There are arguments that Islamic Banking was based on high ethical principles which no longer remain the same. A World Bank paper states that conventional and Islamic banking methods are very similar to each other. Another criticism is that the Islamic bankers find their way around the system and “manage” to get a *shariat* compliance certificate from a scholar to invest in.

However, Islamic banking across the globe is at a comparatively nascent stage and there are plenty of interpretations given by scholars worldwide with regard to various Islamic finance instruments. One cannot completely stick to the purist approach, as the Islamic finance system is centuries old and the modern Islamic Banking system is a recent evolution. The Islamic finance system has to evolve with time without violating the fundamentals of Islamic Finance system as per the *shariat*.

### **India isn't an Islamic country. So why have Islamic banking here?**

While Islamic Banking is prevalent and is common in Islamic countries, there are plenty of non-Islamic countries that are now opening Islamic “windows” in conventional banks. These are departments within the banks and they offer *shariat* compliant products to the customers. China, United Kingdom, United States, Germany are some of the countries that offer Islamic windows. The US has the American Finance House LARIBA which is a *riba* free and *shariat* complaint financial institution that is involved in auto, business, trade financing, hedge fund investing etc. The United Kingdom was the first non-Islamic country to permit a complete *shariat* compliant bank called the Islamic Bank of Britain to operate. In fact, UK was the first Non-Islamic country to have introduced Islamic Bonds known as *sukuk* in the year 2014.

## So how does India benefit from Islamic banking?

Introduction of Islamic Banking was mooted by Raghuram Rajan in his report on the Financial Sector in the year 2008 where he recommended that interest-free banking techniques should be operated on a larger scale so as to give access to those who are unable to access banking services, including those belong to economically disadvantaged section of the society.

There are many advantages in introducing an Islamic window in the banks. For instance, majority of companies in the Stock Exchange are *shariat* compliant (this number is more than the *shariat* complaint companies on the Stock Exchange in Malaysia), thus this would result in attracting huge funds in the domestic market alone.

An Islamic Banking window will encourage many from the Muslim community to come forward and invest in projects thereby mobilising huge amount of capital which they may not be willing to put in the banks. This also means that India will be able to attract huge investments from West Asia and from those who invest only in *shariat* compliant projects.

However, the Indian banking laws will have to be amended so as to incorporate the provisions relating to Islamic banking. For example, the Banking Regulation Act requires payment of interest which is against the principles of Islamic Banking. The Act also specifies “banking” to mean accepting deposits of money from public for lending or investment, thus excluding within its ambit the instruments of Islamic banking that promote profit and loss.

The recent proposal of RBI for opening of an Islamic Banking window has received mixed reactions from many especially in the light of the recent Uniform Civil Code debate and is likely to take a political angle instead of a financial one.

It is pertinent to highlight that investing in *shariat* compliant projects through Islamic Banking windows is something that is mandatory in nature for Muslims, unlike personal laws. For everyone, it will just be an additional financial investment opportunity. It is important to remember that using banking services of one kind need not interfere with the use of another.

## How does Islamic finance work?

At the World Islamic Economic Forum in London, David Cameron has announced the UK is to become the first non-Muslim country to issue Shariah-compliant bonds and that a special Islamic index will be created on the London Stock Exchange. These moves represent a recognition of Islamic finance’s unique model, and of the important role it has to play in providing stable economic growth.

To understand why the UK is so keen to promote this investment, it is worth understanding exactly what sets Islamic finance apart from western models of banking and finance.

The relatively nascent Islamic finance industry finds itself sitting at the cusp of great opportunities but also confronted with major challenges. In the past few years, it has made great advances. Since 2006, the asset base has grown by 150% and is forecast to reach US\$1.8 trillion this year. Given the stability Islamic banks offer, and the strict constraints under which they function, this is a tremendous achievement.

More importantly, this growth is accompanied by a promise of far greater stability than the conventional financial sector provides. This is because of the stringent conditions that Islamic products come with.

### **Global competition**

Expansion to the world's major financial markets pits Islamic banks against much bigger and established players, but the greater size also enables them to standardize products and bring costs down to a level where they can compete head on with conventional banks.

But decades of functioning in well cushioned home markets means Islamic banks have become more relaxed and inefficient than their conventional rivals who operate in a more competitive environment. The coming five years will thus be extremely interesting.

Islamic banks will be making their way into new markets where regulators are increasingly open to accommodating this financial model. In doing so, they will attract many customers from conventional banks. But in order to retain them and make the most of this opportunity Islamic banks will need to develop far more robust risk management protocols than what they currently boast. They will also need to invest heavily in reorganization and raise the level of human resource they depend on right now.

Naturally, some of them will be able to do all this better than others. But regardless of who wins these battles, their arrival on these shores can only be good for existing financial markets.

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