

Islamic Banking-A Challenge for Conventional Banking

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Abstract

Islamic banking and Finance is based on Islamic Sha'riah Laws which provides complete solution to financial problems. According to Islamic law, interest (RIBA) is completely prohibited because interest have many bad affects on the society, individual earning capacity, purchasing power which result in increasing poverty, unequal wealth distribution and credit crisis in an economy, whereas the Conventional banking system or also known as Traditional banking system does not follow any such cultural believes where interest is prohibited. Conventional banking system backbone is interest on loans or interest on investments or interest on credits provided to businesses and various other interests earnings. The basic principles of Islamic Banking is that of sharing profit and loss between the contracted parties and prohibition of Riba (interest).

Key Words: Bai-mua'jjal - deferred payment sale, DIB – Dubai Islamic Bank, Gharar – Uncertainty/Risk, Ijarah – Leasing, Maysir – Speculation, Musharakah - Partnership Finance, Mudarabah - Trust Financing, Murabahah - Cost-plus financing, Quard Hassan – Welfare loan without any fee, Riba – Interest, Sha'riah Laws - Islamic Law, Sukuk – Bonds, Zakah – Charity

Introduction

Islamic financial has long history but Islamic banks and financial industry evolved by profit and loss sharing investment by Egypt's Mit Ghamr Saving Banks in 1963. Islamic banking has grown in many different but somewhere linked fields i.e. of banking, insurance and finance, mortgages, and assets management with growth rate of 10-15% per annum. (DIB) Dubai Islamic Bank is also known as

world's first Islamic bank as it was established in 1975. DIB offer higher rate of returns when compared to conventional banking system, they provide auto, home and personal finance products (Platt, 2008). Islamic teaching says that money has no intrinsic value, itself and forbids people from profiting by lending it, without accepting a level of risk – in other words, interest (known as "Riba") cannot be charged. To earn money from money is prohibited – wealth can only be generated through legitimate trade and investment. Gains relating to any trading are shared between the person providing the capital and the person providing the expertises. Islamic Banking became a threat for Conventional Banking due to its policies. The main drawback of interest based system is that financier is not concerned with the money when he gives an interest bearing loan to a customer. But in Islamic financial contracts money is not given to the client, first they purchase the commodity or property and it is then transferred to client and then all profit and loss will be distributed between the parties according to the terms and conditions of the contract (Usmani, 2005). Islamic banking is for all community because it provides moral and more ethical concept of financing and investment. Islamic banking has many major challenges worldwide because the financial system is more towards the conventional banking but in last decade Islamic banking had made prominent position in the global market.

Statement of Problem

Banks have emerged as very necessary institutions for everyone. Forty years since nationalization, about 60% of the population does not have access to formal banking. This financially excluded class of the country would not hesitate in sharing on their investment but they often find it hard to meet the demands. If finance is available without the burden caused by pre-determined interest rates, it will be a welcome development.

Objective of the Paper

Islamic Banking is trying to attract Non-Muslim customers, who are interested in alternative way of banking. A growing number of Non-Muslim customers are turning to Islamic Banking after being spooked by the turmoil in the banking system. More and more customers see this as a safe and more connected to the real economy. As far as I think Islamic banking system will benefit from this new customers interest and grow even more quickly than it recently did which will sooner than later trigger the panic button in the existing conventional banking system.

Hypothesis

After 9/11, world's oil money has stopped being invested in the United States and they are searching for a safety investment destination. India could be that given its relatively safe economic scenario, skill, huge market and incredible growth rate. Dr. Hussein Hamid Hassan, Chairman, Sha'riah Board, DIB said "Conventional banks since inception, only had one product, that is loan with interest, Sha'riah has unlimited products to suit every customer and every project under any circumstances."

Literature Review

Literature review illustrates the concept, principles and scope of Islamic banking around the world in general and specifically in India. Islamic banking is a universal concept which is in practice

with most of its products mainly in banks like HSBC (India), Dubai Islamic Bank (Dubai), and Islamic Bank of Britain (U.K). I have tried to review the empirically success, opportunities and challenges of Islamic Banks worldwide. This paper has great importance in context of the implementation of Sha'riah laws in India and worldwide.

The Principles of Islamic banking

Principles of Islamic banking are based on Islamic law, known as Sha'riah, which mean:

Interest (Riba)

Interest (Riba) cannot be received or paid on any transaction in any case where money is exchange for money.

Prohibition of Riba (Interest)

“Prohibition of interest from financial activities does not mean that financier cannot earn profit. If financing is for a commercial purpose, it can be based upon the concept of profit and loss sharing, for which financial products like Musharakah and Mudarabah have been created since the inception of Islamic commercial law” (Usmani, 2005, p.10)

Gharar and Maysir

Transactions must avoid uncertainty or risk (Gharar), speculations (Maysir) or anything that can lead to unjust or unfair exploitation of any one of the parties to the contract (Imeson, 2007).

Unethical businesses

Transaction that involve prohibited products or activities like illicit drugs, alcohol and tobacco are avoided. Islam wants to create an ethical and friendly environment in the society (Imeson, 2007).

The Fundamental Principles of Islamic Banking and Finance

Islamic commercial or financial law is based on 3 basic principles. First Islamic business and finance principle is based on profit and loss sharing, Second fixed service fees and charges, Third is free of cost and no charges and other principles change with time and situation of the business. (Bellalah and Ellouz, 2004).

Islamic banking tries to ensure that all the financial matters are in accordance with Islamic financial laws and should follow the country specific rules and regulations in which it is performed. (Shanmugam, Perumal and Ridzwa, 2004).

According to the Sachar Committee report on census 2001 data, the percentage of household receiving banking facilities is much lower in villages then in towns where the Muslim population is high. All this is because of the mindset in banking sector which has categorized Muslims people and Muslims majority areas as “Negative Zones” as cited in the Sachar report headed by Dr. Raghuram Rajan

Why Islamic Banking?

During the downfall of major Wall Street Institutions, notably Lehman Brothers, and then the domino effect of the global financial tsunami and economic recession, Islamic banking emerged as a serious possible alternative to the conventional banking because of the followings reasons:

- Islamic Banking roots are based on Ethical and Socially Responsible Investments (SRI)
- It aims at Equity and Justice and works towards betterment of the society.

- It brings a new dimension to the assets and actual projects for real economic growth instead of just financial engineering.
- It aims to provide services to the population ignored by conventional banks.

Misconceptions and Misunderstandings

According to Khalaf (2007) Islamic banking industry has always suffered with the issue of different in opinions among the Islamic scholars, suppose a product may be accepted by one scholar, but is considered to be Non- Islamic by another.

Justice Mufti Muhammed Taqi Usmani, Chairman, AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) mentions in his famous book titled “An introduction to Islamic Finance”:-

“Islam, being a practical way of life, has two sets of rules: one is based on the ideal objectives of Sha’riah which is applicable in normal conditions, and the second is based on some relaxations given in abnormal situations. The real Islamic order is based on the former set of principles, while the latter is a concession which can be availed at times of need, but it does not reflect the true picture of the real economic order.”

In a secular country like ours, misconceptions among majority community have to be addressed; Islamic Banking is not just for Muslims. It is just a mechanism of financing business without providing any kind of debt. It based on Socially Responsible Investment (SRI).

Financial products of Islamic Banking:

Dr. Hussein Hamid Hassan, (Chairman, Shariah Board, Dubai Islamic Bank) has said “Conventional banks have since inception, had only one product, that is loan with interest, Shariah has unlimited products to suit every customer and every project under any circumstances.”

ISLAMIC SUKUK

Sukuk are asset-backed, tradable, stable income and Sha’riah compatible certificates.

ISLAMIC MORTGAGES

Conventional Mortgages are interest-based, which is a sign as per Islamic Sha’riah law. Islam does not stop from wealth creation, but it must be based on partnerships or fairness where both risks and rewards are shared. (Robins, 1932)

ISLAMIC HOME FINANCING

A fatwa was released for Muslims that, “If no Sha’riah compliant alternatives are available then it is permissible to buy a house using conventional interest-based mortgage with the following restrictions:

- i) The house to be bought must be for the buyer and his family.
- ii) The buyer must not have another house.
- iii) The buyer must not have any surplus assets that can help him to buy a house by means other than a mortgage.”

ISLAMIC MUTUAL FUNDS

Islamic funds are very diverse, as mostly are Equity Funds (84% of the total 126 funds), balanced funds (*secured funds*) 14% and Islamic bond (*Sukuk*) 2%. From the total available Islamic

funds, 35 of them are Global Equity funds (28%), 29 are the Malaysian Equity funds (23%), 10 are American Equity funds (8%), 5 are European equity funds (4%), 5 are Asian equity funds (4%), 13 are Country specific funds – mostly Saudi Arabian, Egyptian and South African (10%), and remaining 8 are Technology and Small-Cap Equity funds (6%).

What is the future of Islamic banking in India?

The future seems to be very bright for Islamic banking in India. Around sixty percent population of the country are not covered by the banks and most of them are marginalized and the minorities. Planning Commission of India held a high level committee on Financial Sector Reforms in 2008 which was headed by Dr Raghuram Rajan, former IMF Chief Economist and some of the high level bankers and few top legal experts and this committee, CFSR, recommended that Interest free banking and financing should be included in the main banking system of India for "inclusive growth with innovation."

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