Islamic Banking

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Abstract- *Islamic banking has proved over time that it is based on Islamic and sound economic principles and has a good potential for become an alternative system of banking especially in view of the global financial crises. However, there is a need for dedicated research & steps from the government to develop a sound legal and regulatory framework for Islamic financial industry. Attempts should be made to modify the existing structure to provide better products and quality service within the ambit of Islamic laws. While interest based banking has taken hundreds of years to mature to the level where it is today, expecting the same maturity from Islamic banking in its nascent stage will be expecting too much. To develop an economic system truly reflective of the sacred principles of Islam, all stakeholders should understand the limitations at this stage and work towards its advancement.*

Keywords- Banking, islamic, investment, finance, currency.

I. INTRODUCTION

Islamic banking, also known as non-interest banking, is a banking system that is based on the principles of Islamic or Sharia law and guided by Islamic economics. Two fundamental principles of Islamic banking are the sharing of profit and loss, and the prohibition of the collection and payment of interest by lenders and investors. Islamic law prohibits collecting interest or "riba."

KEY TAKEAWAYS

Islamic banking, also known as non-interest banking, is a system based on the principles of Islamic or Sharia law and guided by Islamic economics.

Islamic banks make a profit through equity participation which requires a borrower to give the bank a share in their profits rather than paying interest.

Some commercial banks have windows or sections that provide Islamic banking services to customers.

Understanding Islamic Banking

Islamic banking is grounded in Sharia, or Islamic, principles and all bank undertakings follow those Islamic morals. Islamic rules on transactions are called Fiqh al-Muamalat. Typically, financial transactions within Islamic banking are a culturally distinct form of ethical investing. For example, investments involving alcohol, gambling, pork, and other forbidden items is prohibited. There are over 300 Islamic banks in over 51 countries, including the United States.

Principles of Islamic Banking

The principles of Islamic banking follow Sharia law, which is based on the Quran and the Hadith, the recorded sayings, and actions of the Prophet Muhammad. When more information or guidance is necessary, Islamic bankers turn to learned scholars or use independent reasoning based on scholarship and customs. The bankers also ensure their ideas do not deviate from the fundamental principles of the Quran.

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History of Islamic Banking

The origin of Islamic banking dates back to the beginning of Islam in the seventh century. The Prophet Muhammad's first wife, Khadija, was a merchant. He acted as an agent for her business, using many of the same principles used in contemporary Islamic banking.

In the Middle Ages, trade and business activity in the Muslim world relied on Islamic banking principles. These banking principles spread throughout Spain, the Mediterranean, and the Baltic states, arguably providing some of the basis for western banking principles. From the 1960s to the 1970s, Islamic banking resurfaced in the modern world.

505 The number of Islamic banks in 2017, according to a report on global Islamic finance.

How Islamic Banks Make a Profit

To earn money without the use of charging interest, Islamic banks use equity participation systems. Equity participation means if a bank loans money to a business, the business will pay back the loan without interest, but instead gives the bank a share in its profits. If the business defaults or does not earn a profit, then the bank also does not benefit.

For example, in 1963, Egyptians formed an Islamic bank in MitGhmar. When the bank loaned money to businesses, it did so on a profit-sharing model. To reduce its risk, the bank only approved about 40% of its business loan applications, but the default ratio was zero.

Emerging of Islamic banking

Islamic finance has emerged as an effective tool for financing development worldwide, including in non-Muslim countries. Major financial markets are discovering solid evidence that Islamic finance has already been mainstreamed within the global financial system – and that it has the potential to help address the challenges of ending extreme poverty and boosting shared prosperity.

The Islamic finance industry has expanded rapidly over the past decade, growing at 10-12% annually. Today, Sharia-compliant financial assets are estimated at roughly US$2 trillion, covering bank and non-bank financial institutions, capital markets, money markets and insurance ("Takaful").

In many majority Muslim countries, Islamic banking assets have been growing faster than conventional banking assets. There has also been a surge of interest in Islamic finance from non-Muslim countries such as the UK, Luxembourg, South Africa, and Hong Kong.

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Islamic finance is equity-based, asset-backed, ethical, sustainable, environmentally- and socially-responsible finance. It promotes risk sharing, connects the financial sector with the real economy, and emphasizes financial inclusion and social welfare.

Percentage of world market share of Islamic banking industry by country, 2014

Malaysia	15.5
UAE	15.4
Kuwait	10.1
Qatar	8.1
Turkey	5.1
Indonesia	2.5
Rest of the world	7.3

Source: World Islamic Banking Competitiveness Report 2016

Advantages

Over the years, Islamic finance has grown at a rapid pace globally and is now a market worth more than $3.5 trillion. I set out to explain the 5 advantages that Islamic finance offers.

1) It helps by assisting financial inclusion

World Bank defines financial inclusion as 'Financial inclusion means that individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way.' (Worldbank.org, 2017).

The conventional banking system is based on interest payments at a rate pre-set on the deposits of money. Payment and receipt of interest is prohibited under Shariah Law, so Muslims abstain from banking. However, through Islamic banking, financial inclusion can be promoted and bring a larger pool of savings in the local and global economy.

2) Reducing the impact of harmful products and practices

Shariah principles forbid any transactions that support industries or activities which are forbidden in Islam. For example, usury, speculation, and gambling - whether these are legal or not in the place of transaction.

3) Principle of financial justice

Financial justice is a requirement that helps Islamic finance products function in a Shariah compliant way. The Western financial system looks at making profit through interest payments and makes the beneficiary liable for any risk. Islamic finance paves way for the sharing of profit/loss and risk involved in proportional manner

4) Encouraging stability in investments

In Islamic finance, investments are approached with a slower, insightful decision-making process, when compared to conventional finance. Companies whose financial practices and operations are too risky are usually kept away by Islamic financing companies. By performing intensive audits and analyses, Islamic finance promotes the reduction of risk and creates the space for a greater investment stability.

5) Accelerating economic development

Islamic finance companies certainly have profit creation and growth as their objectives. For which, they choose to invest in businesses based on their potential for growth and success. Thus in the Islamic banking industry, each bank will invest in promising business ventures and attempt to out-perform its competitors, in order to attract more funds from its depositors. This will eventually result in a high return on investments both for the bank and the depositors. his is unlikely in a conventional bank, where depositors redeem returns on their deposits based on a pre-determined interest rate.

Disadvantages of Islamic Finance

Not all commercial risk is removed

1. Sharia interpretations of innovative financial products is not always agreed upon
   Some Murabaha are based on prevailing interest rates rather than economic or profit conditions
2. Documentation is often tailor-made for the transaction,so high transaction/issue costs
3. Islamic finance institutions have extra compliance increasing issue / transaction costs.
   Banks need to know more than usual so more due diligence work is required.
4. Islamic banks cannot minimise their risks as hedging is prohibited
5. Some Islamic products may not be compatible with international financial regulation.
6. Trading in Sukuk products has been limited, especially since the financial crisis
7. With no interest - it is hard to claim some Islamic instruments as debt - therefore losing the tax benefit and increasing the WACC
8. Can be difficult to balance the interests of the financial institution with those of other stakeholders.

II. CONCLUSION

Banking is an activity where one is concerned with the management of other people’s money. That is why bankers all over the world are conservative and cautious people. Hence, changes coming to the bank ing sector are usually slow. Furthermore, Islamic banking is just 15 years old. It needs more time to grow and mature. Nevertheless, current scene of Islamic banking is dynamic in which changes within the system are continuously occurring. The need of the hour is to strengthen these emerging trends.

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