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Islamic Banking- A Conceptual Review

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Abstract:

Islamic Banking is a new axiom in the banking and financial sector. Islamic Banking is based on Shariah foundation thus all dealing transaction, business approach, investment focus, are derived from the Shariah law. The main prevailing principles are: The absence of interest-based (riba) transactions; avoidance of economic activities involving oppression (zulm) and speculation (gharar); introduction of an Islamic tax, (zakat); and the discouragement of production of goods and services, which contradict the Islamic value (haram).

This development and growth in Islamic Finance has raised a number of challenges for the resilience and stability of financial systems, and for the protection of their users.

This paper is an attempt to highlight the conceptual , legal and accountable aspect of Islamic Banking .

Paper Type: General Review (Article)

Key Terms: Islamic Banking, Islamic Finance, Shariah Law,

ISLAMIC BANKING

The Islamic financial services industry, with its proposition of inclusiveness, has rapidly progressed across the globe, embracing not only Muslim-majority economies but also other emerging markets and advanced economies. The development of this industry encompasses not only an increase in the business volume and number of institutions offering Islamic financial services , but also an enhanced variety of the products and services offered, improved legal and regulatory infrastructure, and new initiatives for international cooperation. Accordingly, the Islamic financial services industry has gained significant market share, and now constitutes an important building block of the financial systems in many jurisdictions

The fundamental principles of Islamic Banking date back to over 1400 years. Islamic laws and rules governing Islamic Banking are known as *Shariah or Islamic jurisprudence*. Shariah governs all aspects of Islamic matters including worship, economic, social, political and cultural aspects of Islamic societies. The Shariah is derived from three important sources, namely the ***Holy Quran*** (the holy book of the religion of Islam), ***Sunnah***(the practices of the Prophet Muhammad) and ***Ijtihad***(the reasoning of a group of qualified scholars). It revolves around the notion that return on financing (or profit) must be based on ownership and shared profit or loss, so the emphasis is on partnership. These values form the basis of Islamic Banking and all products and services are designed to conform to Shariah laws and principles, reviewed by the ***Shariah Supervisory Board***.

Since the beginning of the 18th century, banking has been conducted on an interest-based system of lending money to those in need. This unfair system lead to hardship and so need for a fair financial system was felt that gave birth to Islamic banking in the mid-1970s. In particular, Islamic law prohibits *usury*, the collection and payment of interest, also commonly called *riba.* Furthermore, the Shariah prohibits what is called "***Maysir***" and ***"Gharar".*** Both concepts involve excessive risk and are supposed to foster uncertainty and fraudulent behaviour. Therefore, the use of all conventional derivate instruments is impossible in Islamic banking.

Islamic Banking has the same purpose as conventional banking: to make money for the banking institute by lending out capital, but that is not the sole purpose. Adherence to Islamic law and ensuring fair play is also at the core of Islamic banking. Because Islam forbids simply lending out money at interest, Islamic rules on transactions (known as *Fiqh al-Muamalat*) have been created to prevent it. Islamic banking introduces concepts such as profit sharing (*Mudharabah*), safekeeping (*Wadiah*), joint venture (*Musharakah*), cost plus (Murabahah), and leasing (*Ijar*). In a mortgage transaction (*Murabahah*) a bank might buy the item itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in installments. However, the bank's profit cannot be made explicit and therefore there are no additional penalties for late payment. Another approach is *EIjarawaEIqtina*, which is similar to real estate leasing. Islamic banks handle loans for vehicles in a similar way. An innovative approach applied by some banks for *home loans,* called *Musharaka al-Mutanaqisa*,- bank and borrower form a partnership entity, rent out the property to the borrower and charge rent i.e. @ floating rates according to the current market rate. Islamic banks lend their money to companies by issuing floating rate interest loans pegged to the company's rate of return. Once the principal amount of the loan is repaid, the profit-sharing arrangement is concluded which is called *Musharaka*. In theory, Islamic banking is an example of full-reserve banking, with banks achieving a 100% reserve ratio.

The original word used for *usury* was *riba,* which literally means “excess or addition”. The criticism of usury in Islam was well established during the lifetime of the Islamic prophet Muhammad and reinforced by several verses in the Qur'an dating back to around 600 AD. This was accepted to refer directly to interest on loans. By the time of *Caliph Umar*, the prohibition of interest was a well-integrated into the Islamic economic system. This interpretation of usury has not been universally accepted or applied in the Islamic world. However, one of the essential descriptions of *riba*is an unjustified delay in payment or either increasing or decreasing the price, if the payment is to purchase a car at an agreed price. The bank generates a profit by determining in advance the cost of the item, its residual value at the end of the term and the time value or profit margin for the money being invested in purchasing the product to be leased for the intended term. The combining of these three figures becomes the basis for the contract between the Bank and the client for the initial lease contract.

Islamic Jurisprudence [Fiqh]: It will be most prudent to comprehend the nature of Islamic jurisprudence, its relevance and impact on Islamic banking. Islamic jurisprudence may be defined as a process by means of which jurists derive, set guidelines, rules and regulations (the Shari'ah) from the principles of the Qur'an and the Sunnah. Muslim contemporary scholars believe that Shariah should be renewed. This would require formulating a *new fiqh*suitable for the modern world.

Accounting Standards

Since its introduction in 1983, the Islamicbank sector has grown considerably in terms of size and market share. The accounting standards for Islamic bank have been developed to comply with the provisions of the different regulations and acts.

The **Islamic Financial Services Board(**IFSB) is an international standard-setting organization which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organization promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process which is outlined in its Guidelines and Procedures , which includes the issuance of exposure drafts, and the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. The IFSB also works closely with relevant international, regional and national organisations, research/educational institutions and market players.

Shariah Supervisory Board

Islamic financial institutions that offer products and services conforming to Islamic principles must, therefore, be governed by a religious board that act as an independent Shari'ah Supervisory Board comprising of at least three Shari'ah scholars with specialised knowledge of the Islamic laws for transacting, fiqh al mu`amalat, in addition to knowledge of modern business, finance and economics.

The role of Shari'ah Supervisory Board members is to review the banking operations, supervise its development of Islamic insurance products, and determine the Shari'ah compliance of these products and the investments. The Shari'ah Supervisory Board have to carry their own independent audit and certify that nothing relating to any of the operations involve any element that is prohibited by Shari'ah. Islamic financial institutions must adhere to the best practices of corporate governance however they have one extra layer of supervision in the form of religious boards. The religious boards have both supervisory and consultative functions. Since the Shari'h scholars on the religious boards carry great responsibility, it is important that only high calibre scholars are appointed to the religious boards. An Islamic financial institution is required to establish operating procedures to ensure that no form of investment or business activity is undertaken that has not been approved in advance by the religious board. The management is also required to periodically report and certify to the religious board that the actual investments and business activities undertaken by the institution conform to forms previously approved by the religious board. They are responsible primarily to give approval that banking and other financial products and services offered comply with the Shari'ah and subsequent verification that of the operations and activities of the financial institutions have complied with the Shari'ah principles (a form of post Shari'ah audit). The Shari'ah Supervisory Board is required to issue independently a certificate of Shari'ah compliance. The day-to-day application of Shari'ah by the Shari'ah Supervisory Boards is two-fold. First, in the increasingly complex and sophisticated world of modern finance they endeavours to answer the question on whether or not proposals for new transactions or products conform to the Shari'ah. Second, they act to a large extent in an investigatory role in reviewing the operations of the financial institution to ensure that they comply with the Shari'ah.

The concept of collective decision-making, in other words, decisions made by more than one scholar, is especially important. Shari'ah Supervisory Boards function is to ensure that decisions are not unilateral, and that difficult issues of finance receive adequate consideration by a number of qualified people.

Shaikh Yusuf TalalDeLorenzo, Islamic scholar, position is that unless a financial product or service can be certified as Shari'ah compliant by a competent Shari'ah supervisory board, that product's authenticity is dubious. At that point, it will be the responsibility of the individual investor or consumer to determine on his or her own that the product complies with the principles and precepts of the Shari'ah.

Conclusion:

Islamic banking is one of the most dynamic segments in the banking industry, andconstitutes a segment in which some of the traditional rules of marketing in thebanking industry may not apply. Undoubtedly, the whole notion of "Islamic banking"implies that this segment must appeal primarily to Muslim customers who use Islamicbanks to fulfill their religious obligations. In the Islamic tradition, if people want toinvest in a business venture, they should do so as partners, sharing both the risk andthe profit. For Muslims, using modern Islamic banks is an obvious choice as theysimultaneously invest their income and fulfill their religious obligations.

In this context, if Islamic banking only appeals to Muslims, then this will naturallyrestrict the growth of the Islamic banking industry. However, if it appeals to non-Muslims as well, the growth potential becomes much larger, and might lead to thesuccessful internationalization of Islamic banking (Khan et al., 2011).

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