Banks & Banking

Islamic Banking: Basic conce

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Islamic banking refers to a system of banking or banking activity which is said to be consistent with Islamic law (Sharia) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called riba in Islamic discourse. Generally, Islamic law also prohibits trading in financial risk (which is seen as a form of gambling). In addition, Islamic law prohibits investing in businesses that are considered haram (such as businesses that sell alcohol or pork, or businesses that produce un-Islamic media). In the late 20th century, a number of Islamic banks were created, to cater to this particular banking market.

Concepts in Islamic debt banking:

Wadiah (Safekeeping): In Wadiah, a bank is deemed as a keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands it. The depositor, at the bank's discretion, may be rewarded with a 'hibah' (gift) as a form of appreciation for the use of funds by the bank. In this case, the bank compensates depositors for the time-value of their money (i.e. pays interest) but refers to it as a "gift" because it does not officially guarantee payment of the gift.

Mudarabah (Profit Loss

ties. The purchase and selling price, other costs and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of interest determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (i.e. the bank cannot charge additional interest on late payments); however, the asset remains in the ownership of the bank until the loan is paid in full.

This type of transaction is similar to "rent-to-own" arrangements for furniture or appliances that are very common in North American stores.

Bai' Bithaman Ajil (Deferred Payment Sale): This concept refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties. This is similar to Murabahah, except that the debtor makes only a single installment, on the maturity date of the loan. By the application of a discount rate, an Islamic bank can collect the market rate of interest.

Wakalah (Agency): This occurs when a person appoints a representative to undertake transactions on his/their behalf, similar to a power of attorney.

Qardul Hassan (Benevolent Loan): This is

rental over a specific period. When the lease period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed price.

In effect, the bank sells the product to the debtor, at an above market-price profit margin, in return for agreeing to receive the payment over a period of time; the profit margin on the lease is equivalent to interest earned at a fixed rate of return.

This type of transaction is particularly reminiscent of contractum trinius, a complicated legal trick used by European bankers and merchants during the Middle Ages, which involved combining three individually legal contracts in order to produce a transaction of an interest bearing loan (something that the Church made illegal).

Bai' al-Inah (Sell and Buy Back Agreement): The financier sells an asset to the customer on a deferred payment basis and then the asset is immediately repurchased by the financier for cash at a discount. The buying back agreement allows the bank to assume ownership over the asset in order to protect against default without explicitly charging interest in the event of late payments or insolvency.

Hibah (Gift): This is a token given voluntarily by a debtor to a creditor in return for a loan. Hibah usually arises in practice when Islamic banks voluntarily pay their customers interest on savings account balances.

Takaful (Islamic Insurance): In modern business, one of the ways to reduce the risk of loss due to misfortunes is through insurance. The basic idea behind insurance is the sharing of risk. The concept of insurance where resources are pooled to help the needy does not contradict Shariah.

Conventional insurance involves the elements of uncertainty (Al-gharar) in the contract of insurance, gambling (Al-maisir) as the consequences of the presence of uncertainty and interest (Al-riba) in the investment activities of the conventional because it does not officially guarantee payment of the gift.

Mudarabah (Profit Loss Sharing): Mudarabah is an arrangement or agreement between a capital provider and an entrepreneur, whereby the entrepreneur can mobilise funds for its business activity. Any profits made will be shared between the capital provider and the entrepreneur according to an agreed ratio, where both parties share in profits and only capital provider bears all the losses if occurred. The profit-sharing continues until the loan is repaid. The bank is compensated for the time value of its money in the form of a floating interest rate that is pegged to the debtor's profits.

Musharakah (Joint Venture): This concept is normally applied for business partnerships or joint ventures. The profits made are shared on an agreed ratio, while losses incurred will be divided based on the equity participation ratio. This concept is distinct from fixed-income investing (i.e. issuance of loans).

Murabahah (Cost Plus): This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parto a power of attorney.

Qardul Hassan (Benevolent Loan): This is a loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor. In the case that the debtor does not pay an extra amount to the creditor, this transaction is a true interest-free loan. Some Muslims consider this to be the only type of loan that does not violate the prohibition on riba, since it is the one type of loan that truly does not compensate the creditor for the time value of money.

Ijarah Thumma Al Bai' (Hire Purchase): These are variations on a theme of purchase and lease back transactions. There are two contracts involved in this concept. The first contract, Ijarah contract (leasing/renting) and the second contract, Bai' contract (purchase) are undertaken one after the other. For example, in a car financing facility, a customer enters into the first contract and leases the car from the owner (bank) at an agreed

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insurance companies which contravene the rules of Shariah. It is generally accepted by Muslim Jurists that the operation of conventional insurance does not conform to the rules and requirements of Shariah.

Takaful is an alternative form of cover which a Muslim can avail himself against the risk of loss due to misfortunes. The concept of takaful is not a new concept; in fact, it had been practised by the Muhajrin of Mecca and the Ansar of Medina following the hijra of the Prophet over 1400 years ago.

Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. Insurance by combining the risks of many people enables each individual to enjoy the advantage provided by the law of large numbers.

Sukuk (Islamic Bonds)

Sukuk is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. However, fixed income, interest bearing bonds are not permissable in Islam; hence, Sukuk are securities that comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

Conservative estimates claim that over US$500 billion of assets are managed according to Islamic investment principles. ■