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### ABSTRACT

The concept of Islamic banking has gained more importance on account of the recent global financial crunch. It is being promoted as an alternative to the much accepted conventional banking as it is based on the principle of asset backed transactions. Islamic banking is banking based on Islamic laws- "Shariah". Islamic laws strictly prohibits interest-Riba thus, Islamic banks function on risk sharing basis i.e. the bank ,the provider of the funds and the user of the fund share the profits and losses equally. This paper is an attempt to understand the principles on which these banks function and how different are they from the conventional banks.

**Keywords:** Islamic banks, Shariah, Riba, Conventional banks, Risk sharing.

### INTRODUCTION

Islamic Banking- a new concept in non-muslim countries is being successfully practiced by many countries in the middle-east and after the recent financial meltdown even the western countries are accepting Islamic banking as an alternative to the conventional banking system. Islamic banking is based on the principles of Islam as governed by Shariah (The original meaning of the Arabic word Shariah is 'the way to the source of life') laws.

### WHAT IS ISLAMIC BANKING?

Islamic Banking is a faith based banking system. The term Islamic banking refers to a system of banking that is in agreement with the basic ideologies of Shariah laws (rules and values set by Islam). Islamic banking is also known as interest free banking system or Ethical banking as the Shariah disallows the acceptance of interest rate ("Riba") for the accepting and lending of money. Islamic banking system, strictly prohibits a business that offers good interest rates it is in fact, considered forbidden (Haraam). Islamic banking also prohibits investment in activities considered immoral, according to Shariah. Thus, investments in projects involving alcohol, tobacco, pork products, weapons and defence, and pornography are all forbidden. The system also prohibits gambling and speculative activities. However, these banks keep their doors open to all, including non-Muslims.

### LITERATURE REVIEW

The concept of Islamic banking has been defined by many scholars. However, there seem to be no difference in overall meaning of the concept as depicted by each one of them. According to Dar and Presley, (2000) An Islamic bank, is just like any conventional bank .i.e. it functions as a financial intermediary and at the same time acts as a trustee and custodian of people's money or financial assets the dissimilarity being that the sharia laws govern its operations. The payoff to its clients is a share in profits and /or loss. Rammal and Zurbruegg (2007) see Islamic Banking as a banking that is based on Islamic sharia law, which follows Islamic rules of transaction. Bello (2007) conveyed that Islamic banking is a system of banking activity which is consistent with the practices and principles of Islamic sharia law and its application to the development of Islamic economics. Chapra (1985): that there is more to Islamic banking than mere abolition of interest was driven home strongly by Chapra. He envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Besides the outlawing of riba, he considered it essential that Islamic banks, since they handle public funds, should play a social-welfare-oriented role rather than a profit-maximizing role. Ahmed(2008) posted that Islamic banks are financial institutions whose rules and procedures clearly state commitment to principles governing Islamic shariah

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law which bans payment or receipt of interest on its operations. To sum the assertions of these scholars, Islamic banking is one that is based on certain unique religious and ethical principles that vary from those of conventional banking.

### THE OBJECTIVES OF THIS PAPER ARE

1. To give an overview of the concept called Islamic Banking.
2. To understand the principles on which these banks functions.
3. To understand the difference between Islamic Banking and conventional banking.

### EVOLUTION OF ISLAMIC BANKING

The first Islamic Bank in the world was founded in Egypt in 1963, The Mit Ghamr Local Savings Bank in Egypt. The bank could not survive and had to close its doors after 2 years for different reasons including the lack of resources and support, but paved the way for modern Islamic banking and since then; the phenomenon has grown slowly but steadily. The establishment of Islamic Development Bank in 1975 paved the way for the establishment of other Islamic banks in various Muslim countries. There are currently more than 200 interest-free institutions. Many conventional banks also offer Islamic banking products and services to both Muslim and non-Muslim customers. Products and services at Islamic banks are compatible to those of conventional banks. As a result of these developments, the first International Financial Market commercial operation started in Bahrain at the end of 2001.

Currently, there are 325 Islamic banks operating across the globe though most of them are based in Islamic countries, there is a trend of new Islamic banks increasingly emerging in other parts of the world as well. For instance, there are 2 Islamic banks in Australia, 6 in Bahamas and 38 in the United States of America. Denmark, France and Ireland have one each, while Germany and Switzerland boast five Islamic banks in each country respectively. Great Britain has 23 Islamic banks and Luxemburg has 4. Bosnia and Herzegovina has one bank each which operates under the Islamic banking principles.

### PRINCIPLES OF ISLAMIC BANKING

The principles of Islamic banking are approved in the holy Qur'an, which Muslims believe are the revered words of God as revealed to the Prophet Mohammed. These principles of Islamic banking have been therefore categorised into four individual concepts.

- **Proscription of Interest:** The Shariah Law strictly prohibits Interest or Riba or Usury. According to this principle of Islam the lender does not charge any interest or additional amount over the money lent. The underlying principle is that when money is made from money (by way of interest) it threatens the well-being of the entire society as the investors then become more interested in the rate of interest and returns assured that they do not bother about the uses to which their money is put, the result of which may be negative.
- **Moral Standards:** This principle concerns the investment activities being undertaken by the Islamic banks. According to Shariah Law all the investments made should be for the well-being and benefit of the society and the environment. Thus, investments in activities like trading in alcohol, gambling, real estate for constructing casinos etc. are strictly prohibited in Islamic Banking. Even when investing in share trading or securities market these banks should check the activities being undertaken by the companies to establish the fact that the companies business is in line with the Shariah Law.
- **Social Standards:** This principle believes that Islamic banks should undertake social projects in their attempt to serve the society. Most importantly these projects should be in the form of profit free loans given for a short period of one year. This way, these banks will help in promoting just and equitable distribution of income and wealth in the society.
- **Liability and Business Risk:** This principle attempts to explain that Islamic banks should be fair in their distribution of risk or uncertainty. Therefore, the financier has a rightful share in the profits only when he undertakes certain responsibility which can be in the form of supplying an asset or any other assistance. Shariah law clearly states that "Profit comes with liability" i.e. he who agrees to bear the risk or liability of loss will be entitled to a share in profits.

## CONVENTIONAL BANKING V/S ISLAMIC BANKING

Islamic banking and Conventional banking are basically into the business of handling funds however, they differ from each other on the following points:

1. **PRINCIPLES:** The functions and operations performed by conventional banks are based on the principles established by Human beings. Islamic banks perform their functions and operations according to the Shariah laws i.e. as per the directives of Holy Quran.
2. **AIM:** Conventional banking aims at maximisation of profits and Islamic banking strives for an interest-free financial system.
3. **REWARDS:** Investors under conventional banking are assured a predetermined rate of interest. As Islam strictly prohibits profits earned on investments without any effort or hard work, risk sharing between provider and user of funds forms the basis of Islamic Banking. Hence, Islamic banking is all about sharing of profits as well as losses.
4. **DEFAULT IN PAYMENTS:** Defaulters have to pay penalty and compounded interest in conventional banking. Islamic banking does not penalise defaulters however, if at all charged the proceeds are given to charity.
5. **SIGNIFICANCE:** Clients credit-worthiness is of extreme significance in conventional banking. Islamic banks give more importance to the viability of a project.
6. **SOCIAL RESPONSIBILITY:** Islamic banks are more concerned with the social welfare and equitable distribution of wealth in the society it thus, prohibits interest in exchange for funds provided. This way people do not get tempted for saving capital by withdrawing it from investment process, which may be detrimental to society.
7. **SUPERVISION AND REGULATIONS:** Just as supervisory issues such as capital adequacy ratios in conventional banking are regulated by the Basel Committee on Banking Supervision (BCBS), Islamic banks follow the standards prescribed by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

8. **RELATIONSHIP:** In conventional banking the relation between a bank and its client is that of Debtor and Creditor. But in Islamic banking the status of Islamic Bank in relation to its clients is that of partners, investors and trader, buyer and seller.

## CONCLUSION

Islamic banking therefore, provides moral and ethical concept of financing and investment to individuals and communities that seek ethical financial solutions. It is not only Islamic or specific banking but actually it is a system which is really supportive in creating a peaceful, economically prosperous and welfare society.

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