What is Islamic Banking?

Islamic banking is defined as banking system which is in consonance with the spirit, ethos and value system of Islam and governed by the principles laid down by Islamic Shariah. While Islamic banking has a broader scope and meaning, it is generally referred to the transformation of conventional money lending system into Asset-backed financing transactions conducted by the Financial Institutions.

What is meant by Shariah/Islamic Law?

Shariah lexically means a way or path. In Islam Shariah refers to the divine guidance and laws given by the Holy Quran, the Hadith (sayings) of the Prophet Muhammad (Sallalahu Alaihi Wassalam) and supplemented by the juristic interpretations by Islamic scholars. Shariah embodies all aspects of the Islamic faith, including beliefs and practices. Islamic Shariah or the divine law of Islam is derived from the following four sources:

1. The Holy Quran
2. The Sunnah of the Holy Prophet (Peace Be Upon Him)
3. Ijma’ (consensus of the Ummah)
4. Qiyas (Anology)

What is the philosophy of Islamic banking?

The philosophy of Islamic banking takes the lead from Islamic Shariah. According to Islamic Shariah, Transactions involving interest/riba, Gharar and Maiser are prohibited. Moreover, they cannot deal in any transaction, the subject matter of which is invalid (haram in the eyes of Islam). Islamic banks focus on generating returns through investment tools which are also Shariah compliant. Islamic Shariah links the gain on capital with its performance. Operating within the ambit of Shariah, the operations of Islamic banking are based on sharing the risk which may arise through trading and investment activities using contracts of various Islamic modes of finance.

Riba, Gharar & Maiser

Riba: An increase stipulated or sought over the principal of a loan or debt and implies any excess compensation without due consideration (consideration does not include time value of money).
Gharar: Excessive level of uncertainty or ambiguity created due to the lack of information or control in a contract
Maisar: Game of Chance or speculation

Quran (Surah Al Baqarah 2:278-9)
"O those who believe; fear Allah and give up what still remains of the Riba if you are believers. But if you do not do so, then be warned of war from Allah and His Messenger. If you repent even now, you have the right of the return of your principal; neither will you do wrong nor will you be wronged."

It is reported by Harith ibe Abi Usamah in his Musnad that Sayyidna Ali Radi-Allahu Anhu reportedly referred that the Holy Prophet S.A.W. said:

"Every loan that derives a benefit (to the lender) is riba".

**Does interest/Riba is related only to consumption loans or it applies to commercial loans also?**

The interest is prohibited whether it is consumption loan (loan for meeting day to day human needs) or commercial loan (loan for business purpose). There are quite a number of ahadith which clarify that in the days of Holy prophet, people not only borrowed for consumption purposes but also for productive purposes. A few of the ahadith are given as follows for reference:

(i) Ibn Saad has reported Hazrat Umar (Radi-Allahu anhu), wanted to send a trade caravan to Syriya. He borrowed four thousand dirhams from Sayyidna Abdurrahman ibn Awaf (Radi-Allahu anhu), for this purpose.

(ii) Ibn Jarrir has reported that Hind, daughter of Utbah and wife of Abu Sufyan borrowed four thousand dirhams from Sayyidna Umar (Radi-Allahu anhu), for the purpose of her trade. She invested this money in purchasing goods and selling them in the market of the tribe of Kalb.

This is an ample testimony that the commercial loan was in practice when Quranic verses on Riba were revealed and the term Riba covers not only consumption loan but also the commercial loan.
## Differentiating features of Islamic and conventional banking

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<tr>
<th>Conventional Banking</th>
<th>Islamic Banking</th>
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<td>The functions and operating modes of conventional banks are based on man-made principles.</td>
<td>The functions and operating modes of Islamic banks are based on the principles of Shariah i.e. the divine guidance.</td>
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<td>Money is treated as a commodity, besides medium of exchange and store of value. Therefore, it can be sold at a price higher than its face value and it can also be rented out.</td>
<td>Money is not regarded as a commodity, though it is used as a medium of exchange and store of value. Therefore, it cannot be sold at a price higher than its face value or rented out.</td>
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<td>Conventional banking practices are concerned with the elimination of risk.</td>
<td>Reward should be a consequence of undertaking a risk. It’s all about risk taking and risk sharing.</td>
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<td>The investor is assured of a predetermined rate of interest.</td>
<td>In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).</td>
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<td>Time value is the basis for charging interest on capital.</td>
<td>Profit on trade of goods or charging on providing service is the basis for earning profit.</td>
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<td>Interest is charged even in case the organization suffers losses by using bank’s funds. Therefore, it is not based on profit and loss sharing.</td>
<td>Islamic bank operates on the basis of profit and loss sharing. In case, the businessman has suffered losses, the bank will share these losses based on the mode of finance used (Modaraba, Musharaka).</td>
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<td>While disbursing cash finance, running finance or other working capital finance, no agreement for exchange (trade) of goods and services is made.</td>
<td>The execution of agreements for the exchange of goods and services is a must, while disbursing funds under Murabaha, Salam and Istisna contracts (Trade-base transactions).</td>
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<td>Conventional banks use money as a commodity which leads to inflation.</td>
<td>Islamic banking tends to create link with the real sectors of the economic system by using trade related activities. Since, the money is linked with the real assets therefore it contributes directly in the economic development.</td>
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<td>The status of a conventional bank, in relation to its clients, is that of creditors and debtors.</td>
<td>The status of Islamic bank in relation to its clients is that of partners, investors and trader, buyer and seller, as well as, lessor and lessee.</td>
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<td>Involvement of economic activities involving speculation and gambling elements (Gharar).</td>
<td>Islamic banking transactions are Gharar-free transactions. It ensures mutual benefit, covering and spreading risks of both counter parties to the contract by making each one’s obligations clear at the outset.</td>
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<td>It can charge additional money (penalty and compounded interest) in case of defaults.</td>
<td>The Islamic banks have no provision to charge any extra money from the defaulters. Instead an amount of payment is charged and these proceeds are given to charity.</td>
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<td>Conventional banks do not discourage the production of goods and services in any way which contradict the Islamic values.</td>
<td>On the other hand, Islamic banks do not provide any assistance and strictly discourages the production of goods and services which are against the Islamic values (Haram).</td>
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The end result of Islamic Banking and Conventional Banking is the same. Why do they appear similar?

The validity of a transaction does not depend on the end result but rather the process and activities executed and the sequence thereof in reaching the end. If a transaction is done according to the rules of Islamic Shariah it is halal even if the end result of the product may look similar to conventional banking product.

For example a normal McDonalds burger in USA and Pakistan may look similar, smell similar and taste similar but the former is haram and the later is halal due to its compliance of Islamic guidelines of slaughtering animals. Similarly, if a person is feeling hungry, he may steal a piece of bread and eat or alternatively buy a piece of bread to eat. The apparent end result would be same but one is permissible in Shariah and the other is not allowed. The same is also true for Islamic and conventional banking. Therefore, it can be concluded that it is the underlying transaction that makes something “Halal” (allowed) or “Haram” (prohibited) and not the result itself. Apparently, Islamic banks may look similar to conventional banks, however the contracts and product structures used by Islamic banks are quite different from that of the conventional bank. In the verse 2:275 of the Holy Quran, Allah the Almighty has responded to the apparent similarity between trade and interest by resolutely informing that he has permitted trade and prohibited Riba (though they may look similar to someone).

If Islamic banks do not invest in interest based activities then how do they generate profit to pay to their customers?

The Islamic bank uses its funds in various trade, investment and service related Shariah compliant activities and earns profit thereupon. The profit earned from such activities is passed on to the depositors according to the agreed terms.

Are not Islamic banks just paying interest and dressing it as profit on trade and investments?

No, Islamic banks accept the deposits either on profit and loss sharing basis or on Qard basis. These deposits are deployed in financing, trading or investment activities by using the Shariah compliant modes of finance. The profit so earned by the bank is passed on to the depositors according to the pre-agreed ratio which, therefore, cannot be termed as interest.

Islamic banks use interest base system (KIBOR) as a Bench Mark while determining profit; how Islamic banking can be said to be Islamic?

Islamic banks should ideally have their own benchmark system for determination of profit. Since, the industry is in its initial stage of development, it is using the available benchmark for the banking industry. It is expected that once it is grown to a sizable level, it would have its own benchmark. However, using Interest Rate benchmark for determining the profit of any
permissible transaction does not render the transaction as invalid or haram. It is the nature/mechanism of the transaction that determines its validity or otherwise.

For example Mr. A and Mr. B are two neighbors. Mr. A sells liquor which is totally prohibited in Islam whereas Mr. B, being a practicing Muslim dislikes the business of Mr. A and starts the business of soft drinks. Mr. A wants his business to earn as much profit as Mr. A earns through trading in liquor. Therefore he decides that he will charge the same rate of profit from his customers as Mr. A charges over the sale of liquor. Thus he has tied up his rate of profit with the rate used by Mr. A in his prohibited business. One may say that Mr. B uses an undesirable benchmark in determining the rate of profit, but obviously no one can say that the profit charged by him is haram because he has used the rate of profit of the business of liquor only as a benchmark. The same is true for Islamic banks, it is most desirable and preferable that Islamic banks develop their own benchmark however; in the absence of any such alternative, interest rate related benchmark can be used.
Most widely used types of Islamic finance Contracts:

Trade based modes

- **Murabaha**: A Sale-Purchase contract on mutually agreed profit in which the seller disclosed the cost and profit separately.

- **Salam**: A Sale-Purchase contract where the seller agrees to supply goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract.

- **Istisna**: A Sale-Purchase contract for manufactured goods / constructed assets, whereby payment is generally made in advance. The goods are eventually sold in market to earn profit.

Lease based modes

- **Ijarah**: A Rental contract where Assets, Services / Benefits are rented/ rendered over a period.

- **Ijarah Muntahia Bittamleek**: A form of Ijarah which includes a promise by the lessor to transfer the ownership of the leased asset to the lessee, either at the end of the lease term or in stages during the term of the contract.

- **Diminishing Musharakah**: It is a form of partnership in which one of the partner's promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him. Till the time ownership is completely transferred the other partner pays rent for the usufructs of the Asset in his/ her use.

Participatory modes

- **Musharaka**: A relationship established under a mutually agreed contract between the parties for sharing of profits and losses arising from a joint entrepreneurship or venture.

- **Modaraba**: A participatory mode of finance where one party provides the capital (Rab-ul-Maal) while the other provides human capital (i.e. entrepreneurship and efforts) needed for the economic activity to be undertaken. Profit earned is shared between the two parties on a pre-agreed ratio, while loss is borne only by the provider of the capital.