Challenges before Management (Finance)
Islamic Banking- A Challenge for Conventional Banking

Mrs. Khushali Oza
Assistant Professor, MBA Department
Suryadatta Institute of Management and Mass Communication
Pune

Abstract:
Islamic Banking and Finance is based on Islamic Sha’riah Laws which provides complete solution to some burning financial problems. Interest (Riba) is completely prohibited because interest have many bad effects on the society, individual earning capacity, purchasing power which result in increasing poverty, unequal wealth distribution and credit crises in an economy, whereas the conventional banking system or also known as traditional banking system does not follow any of such cultural believes where interest is prohibited. Conventional banking system’s backbone is interest on earnings. The basic principle of Islamic banking is that of sharing profit and loss between the contracted parties and prohibition of Riba (Interest).

Key words: Riba- Interest, DIB- Dubai Islamic Bank, Gharar- Uncertainty/risk, Maysir- speculation, Musharakah- partnership finance, Mudarabah- Trust financing, Murabahah- cost plus financing, Sha’riah Laws- Islamic Law, Sukuk- Bonds

Introduction: Islamic banking refers to a system of banking or banking activity that is consistent with the principles of the Shari’ah (Islamic rulings) and its practical application through the development of Islamic economics. The principles which emphasise moral and ethical values in all dealings have wide universal appeal. Shari’ah prohibits the payment or acceptance of interest charges (riba) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles. While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20th century that a number of Islamic banks were formed to provide an alternative basis to Muslims although Islamic banking is not restricted to Muslims.

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shari’ah, known as Fiqh al-Muamalat (Islamic rules on transactions). Islamic banking activities must be practiced consistent with the Shari’ah and its practical application through the development of Islamic economics. Many of these principles upon which Islamic banking is based are commonly accepted all over the world, for centuries rather than decades. These principles are not new but arguably, their original state has been altered over the centuries.

Origin: The origin of the modern Islamic bank can be traced back to the very birth of Islam when the Prophet himself acted as an agent for his wife’s trading operations. Islamic partnerships (mudarabah) dominated the business world for centuries and the concept of interest found very little application in day-to-day transactions.

Such partnerships performed an important economic function. They combined the three most important factors of production, namely: capital, labour and
entrepreneurship, the latter two functions usually combined in one person. The capital-owner contributed the money and the partner managed the business. Each shared in a pre-determined share of the profits. If there was a loss, the capital-provider lost his money and the manager lost his time and labour.

**Statement of Problem:** Banks have emerged as very necessary for everyone. Forty five years since nationalization, about 60% of population does not have access to formal banking. This financially excluded class of the country would not hesitate in sharing on their investment but they often find it hard to meet the demands. If finance is available without the burden caused by pre-determined interest rates, it will be welcome development.

**Objective:** Islamic banking is trying to attract non-muslim customers, who are interested in alternative way of banking. A growing number of non-muslim customers are turning to Islamic banking after being spooked by the turmoil in the banking system. More and more customers see this as a safe and more connected to the real economy. As far as I think Islamic banking system will benefit from this new customers interest and grow even more quickly than it recently did which will sooner than later trigger the panic button in the existing conventional banking system.

**Hypothesis:** After 9/11, world’s oil money has stopped being invested in the United States of America and they are searching for safest investment destinations. India could be do that given its relatively safe economic scenario, skills, huge market and incredible growth rate.

**Literature Review:** Literature review illustrates the concept, principles and scope of Islamic banking around the world in general and specifically in India. Islamic banking is a universal concept which is in practice with most of its products mainly in banks like HSBC(India), Dubai Islamic bank (Dubai), and Islamic bank of Britain (U.K). I have tried to review the empirically success, opportunities and challenges of Islamic bank world wide. This paper has great importance in context of the implementation of Sha’riah laws in India and worldwide.

**The principles of Islamic Banking:**

- **1- Prohibition of Interest or Usury:** The principles of Islamic finance are established in the Qur’an, which Muslims believe are the exact Words of God as revealed to the Prophet Mohammed. These Islamic principles of finance can be narrowed down to four individual concepts.

  The first and most important concept is that both the charging and the receiving of interest is strictly forbidden. This is commonly known as Riba or Usury. Money, on its own, may not generate profits. When Riba infects an entire economy, it jeopardises the well-being of everyone living in that society. When investors are more concerned with rates of interest and guaranteed returns than they are with the uses to which money is put, the results can only be negative.

  **2- Ethical Standards:** The second guiding principle concerns the ethical standards. When Muslims invest their money in something, it is their religious duty to ensure that what they invest in is good and wholesome. It is for this reason that Islamic investing includes serious consideration of the business to be invested in, its policies, the products it produces, the services it provides, and the impact that these have on society and the environment. In other words, Muslims must take a close look at the business they are about to become involved in.

  **3- Moral and Social Values:** The third guiding principle concerns moral and social
values. The Qur'an calls on all its adherents to care for and support the poor and destitute. Islamic financial institutions are expected to provide special services to those in need. This is not confined to mere charitable donations but has also been institutionalised in the industry in the form of profit-free loans or Al Quard Al Hasan.

4- Liability and Business Risk: The final principle concerns the overarching concept of fairness, the idea that all parties concerned should both share in the risk and profit of any endeavor. To be entitled to a return, a provider of finance must either accept business risk or provide some service such as supplying an asset, otherwise the financier is, from a Sharia'a point of view, not only an economic parasite but also a sinner. This principle is derived from a saying of the Prophet Mohammed (May Peace be upon Him) "Profit comes with liability". What this means is that one becomes entitled to profit only when one bears the liability, or risk of loss. By linking profit with the possibility of loss, Islamic law distinguishes lawful profit from all other forms of gain.

Why Islamic Banking?
During the downfall of major Wall Street institutions, notably Lehman Brothers, and the the domino effect of the global financial tsunami and economic recession, Islamic banking emerged as a serious possible alternative to the conventional banking because of following reasons-

1) Islamic banking roots are based of Ethical and Socially responsible investments (SRI)
2) It aims at equity and justice and works towards betterment of society.
3) It brings a new dimension to the assets and actual projects for real economic growth instead of just financial engineering.

4) It aims to provide services to the populations ignored by conventional banks.

The fundamental of Islamic banking and finance-
Islamic commercial or financial law os based on 3 basic principles-
- Profit and loss sharing
- Fixed service fees and charges
- Prohibition of Riba, Gharar and Maysir

According to the Sachar committee report on census 2001 data, the percentage of household receiving banking facilities is much lower in villages then in towns where the Muslim population is high. All this is because if mindset in banking sector which has categorized Muslim people and muslim majority areas as ‘Negative Zones’ as cited in the Sachar report headed by Dr. Raghuram Rajan.

Misconceptions and misunderstandings:
It’s easy to assume that Islamic finance is a mere replica of conventional finance, seeing as there are many similarities between the two, especially in terms of the economic objectives for end users. Because the distinction between these two forms of finance is not obvious, it’s easy for critics to disregard the differences.

However, the fact remains that at its root, Islamic finance is governed by some fundamental principles that are very different from conventional finance, including prohibitions against riba (usury/interest), maisir (betting/gambling) and gharar (dubious ambiguity), which Islamic Finance products are designed to remove. Similarly, Shariah compliant stock indices have constantly performed differently from non-Shariah compliant indices, and the Islamic finance sector has been far more resilient in the face of the global financial crisis.

Another big misconception about Islamic Banks is that it is for Muslims only, but one
that is far easier to address than most, seeing as conventional banking groups such as Citigroup, HSBC and Standard Chartered, among others, are already offering Islamic financial services. This is proof that no prohibition exists in terms of the use of Islamic financial products by non-Muslims, nor are there laws stating that non-Muslims may not own institutions offering such products and services.

As for the prohibition against usury, that is, investments in unethical or immoral sectors such as alcohol, gambling and pornography, it should be noted that other major world religions including Christianity, Judaism, Buddhism and Hinduism also impose this restriction. Many non-Muslims abstain from investing in such businesses as well, whether as a matter of religious, cultural or personal principle.

Financial Products of Islamic Banking:
Dr. Hussain Hamid Hassan, Chairman, Shariah Board, Dubai Islamic Bank has said:” Conventional banks have since inception, had only one product, that is loan with interest, Shariah has unlimited products to suit every customer and every project under any circumstances”

Islamic Sukuk- Islamic Sukuk are shares in the ownership of tangible assets with reference to a particular project or an investment activity.

Murabahah- Murabahah refers to the sale of goods at a price which includes a profit margin. Banks offer it by combining Murabahah and Deferred Payment.

Musharakah - Musharakah is a partnership-based contract or an investment with a partnership structure for sharing profits and losses, based on the Sharee’ah

Mudarabah -Mudarabah is an equity-based contract, which is based on the Islamic Shari’ah. It involves investment from one partner and effort from other.

Islamic home financing- A Fatwa was released by Muslims that ,” IF no Shariah complaint alternatives are available then it is permissible to buy a house using conventional interest based mortgage with the following benefits-

- A product that is based on a Diminishing Musharaka agreement. This agreement allows you to purchase the bank's portion over a term suitable to you
- A competitively priced deal
- Re-financing options on paid up property
- Eligibility to purchase additional units of the banks portion at anniversary date
- eBucks rewards

Islamic mutual funds- The performance of Islamic mutual funds in Malaysia is measured according to four types of asset portfolios which are Equity, Debt, Money Market and Asset Allocation. Using Sharpe and Adjusted Sharpe Ratio, Treynor and Jensen Indices as well as Modigliani Measure, the average daily returns for each type of asset fund are being compared relatively to two market benchmarks namely Kuala Lumpur Composite Index (KLCI) and Bursa Malaysia EMAS Shariah Index (FBMS). The period of comparison is divided into three; between 2001 to 2006 which is before Global Financial Crisis, during the period of crisis from 2007-2008 and post crisis of 2009 to 2010. Findings show that generally, all types of asset fund are being compared relatively to two market benchmarks namely Kuala Lumpur Composite Index (KLCI) and Bursa Malaysia EMAS Shariah Index (FBMS). The period of comparison is divided into three; between 2001 to 2006 which is before Global Financial Crisis, during the period of crisis from 2007-2008 and post crisis of 2009 to 2010. Findings show that generally, all types of asset fund are being compared relatively to two market benchmarks namely Kuala Lumpur Composite Index (KLCI) and Bursa Malaysia EMAS Shariah Index (FBMS). The period of comparison is divided into three; between 2001 to 2006 which is before Global Financial Crisis, during the period of crisis from 2007-2008 and post crisis of 2009 to 2010. Findings show that generally, all types of asset fund are being compared relatively to two market benchmarks namely Kuala Lumpur Composite Index (KLCI) and Bursa Malaysia EMAS Shariah Index (FBMS). The period of comparison is divided into three; between 2001 to 2006 which is before Global Financial Crisis, during the period of crisis from 2007-2008 and post crisis of 2009 to 2010. Findings show that generally, all types of asset fund are being compared relatively to two market benchmarks namely Kuala Lumpur Composite Index (KLCI) and Bursa Malaysia EMAS Shariah Index (FBMS).
benchmarks and the outperformance is continued until 2010. The under performance results were only shown through Debt and Money Market Islamic Mutual funds from 2001 to 2006. The results provide information that would benefit the investors and market players in asset funds selection and weighing their investment during bullish or bearish periods.

Future of Islamic banking in India: New Delhi, Jan 9: Muslim economists have welcomed the recommendation of a committee of India's federal bank to allow interest-free window in commercial banks in order to ensure financial inclusion. The Committee on Medium Term Path for Financial Inclusion of Reserve Bank of India released its report on 28th Dec 2015 recommending measures to increase financial inclusion in the country. One of the major recommendations is opening interest-free windows in existing conventional banks. On the benefits of the interest-free window, Dr Anwar said: "More and more people will come to banks and save their money. More than 80% people do not take part in banking. If Islamic finance is started these people will come to banks with their small savings."

Prof Jawed Ahmad Khan, economist and expert on West Asia affairs also welcomed the move saying it will attract huge investment from Arab world. "India needs infrastructure financing on long terms. If sukook system is adopted, India will attract huge investment from Arab world. Indian Muslims will also use their savings in investment activities," said Prof. Khan.

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