

INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE, ECONOMICS & MANAGEMENT

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ISLAMIC BANKING: A INTRODUCTION

MOHD SAZID

ASST. PROFESSOR

DEPARTMENT OF COMMERCE

PANJAB UNIVERSITY CONSTITUENT COLLEGE

GURU HAR SAHAI

ABSTRACT

Today when the world is going through the period of global depression, the question comes in mind that are there some ways to avoid or minimise the effects of depression. We are countering with the problem of insolvency. We all know that the one of the main reason behind the insolvency is occurring of continuous losses and existence of fixed interest charges such as interest, rent etc. This research paper was aimed to explain and analyse the main principles and ways of Islamic banking. A descriptive research based upon the literature review was conducted. It was tried to illustrate the Islamic banking principles in relation with the main activities of traditional finance.

KEYWORDS

Islamic banking, ribah, mudarbah, ijarah, qard hassan.

1. INTRODUCTION

The foremost belief around which all Islamic concepts resolve is that the whole universe is created by only one god. He has created the men and appointed him the vicegerent on the earth to fulfill certain objectives through certain objectives his commands. These commands are not restricted to just modes of worship rather these cover a substantial part of our life and almost every aspect of our life. Recently we heard about the Islamic banking and its usefulness to the economy. So that this research paper aims to provide the introduction about basic principles and practices of Islamic banking.

2. IMPORTANCE OF THE STUDY

This study was done to enquire about some common principles of Islamic banking. As we know that the world is going through the period of depression. People are going bankrupt or insolvent. We all know that the one of the main reason behind insolvency is occurring of losses and existence of fixed expenses such as interest, rent etc. Islamic banking can provide a solution to this problem because Islam completely bans the acceptance of interest and advocates the sharing of profit and losses. So that, there are very less chances that a person can be declared insolvent.

3. OBJECTIVES OF THE STUDY

The objective of this study was to explain the Islamic principles and analysis of their benefits to the society. The focus was on the analysis of main Islamic principles of financing covering ribah (interest), Mudarbah (sharing of capital along with sharing of results), Qard-al-Hassan (interest free loan) and Ijarah-wal-iqtina (leasing).

4. RESEARCH METHODOLOGY

For the purpose of this research various websites related with the Islamic finance along with Wikipedia were used to collect the data and thereafter a literature review was done. Basically a descriptive research was conducted to explain the concepts of utmost importance in the area of finance.

5. REVIEW OF LITERATURE

MEANING OF ISLAMIC BANKING

As per Wikipedia, "Islamic banking is banking or banking activity that is consistent with the principles of sharia (Islamic law) and its practical application through the development of Islamic economics. As such, a more correct term for Islamic banking is sharia-compliant finance."¹ According to institute of Islamic banking and insurance, "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."²

FEATURES OF ISLAMIC BANKING

The Islamic banking has many distinguished features which make it different from the traditional banking:

A. PROHIBITION ON RIBA (INTEREST)

The word "riba" literally means "excess" or "addition", and has been translated as interest, usury, excess, increase or addition. According to *Shariah* terminology, it implies any excess compensation without due consideration (consideration does not include time value of money).³

The Shari'ah prohibits the payment of charges for the renting of money (riba, which in the definition of Islamic scholars covers any excess in financial dealings, usury or interest) for specific terms, as well as investing in businesses that provide goods or services considered contrary to its principles (Haram, forbidden)⁴ The Islam strongly opposes the accepting of interest in return of lending the money. Normally the interest is charged for loss of purchasing power and due the concept of time value of money. But Islam does not recognise time value of money. Interest is simply considered as haram which mean sinful or prohibited.

B. MUDARABAH (ISLAMIC WAY OF LENDING)

The first question that comes in mind that why one will lend if he is not going to get the benefits such as interest. This question is answered here.

Under Islamic banking system, the two persons co-operate with each other on the basis of partnership, where the capital-owner provides the capital and the other party puts his management skills into the business. The capital-owner is not involved in the actual day-to-day operation of the business, but is free to stipulate certain conditions that he may deem necessary to ensure the best use of his funds. After the expiry of the period, which may be the termination of the contract or such time that returns are obtained from the business, the capital-owner gets back his principal amount together with a pre-agreed share of the profit. The ratio in which the total profits of the enterprise are distributed between the capital-owner and the manager of the enterprise is determined and mutually agreed at the time of entering the contract, before the beginning of the project. In the event of loss, the capital-owner bears all the loss and the principal is reduced by the amount of the loss. It is the risk of loss that entitles the capital-owner to a share in the profits. The manager bears no financial loss, because he has lost his time and his work has been wasted. This is, in essence, the principle of mudarabah.⁵

The above system is called mudarabah which is in convergence with the Islamic law.

C. IJARAH-WAL-IQTINA (CONTRACT OF LEASE)

A contract under which an Islamic bank provides equipment, building, or other assets to the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profit over the period of lease.⁵

Lease-and-purchase transaction; a financing instrument used by practitioners of contemporary Islamic finance in which a financier purchases reusable merchandise (e.g. airplane, buildings, cars) and then leases them to clients in return for an agreed upon rental fee (to be paid for the length of the lease period) and an agreement that the client will purchase the merchandise at the end of the lease period.⁶

So that, this is another way of finance or you can say it is contract of financial lease. Further it is to be added that the interest of delayed payment of rent is again prohibited, in short, lessor cannot charge late payment charges if the lessee fails to pay the rent on time.

D. QARD HASSAN (GOOD LOAN)

Qard hassan is a loan extended on a goodwill basis, with the debtor 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*, for it alone is a loan that truly does not compensate the creditor for the time value of money.⁷

Qard-al-hassan refers to an interest-free loan (fungible, marketable wealth) that is extended by a lender to a borrower on the basis of benevolence (ihsan or irfaq). Al-qard, from a shari'a point of view, is a noncommutative contract, as it involves a facility granted only for the sake of tabarru' (donation). Therefore, al-qard al-hassan is a gratuitous loan extended to needy people for a specified period of time. At the end of that period, the face value of the loan (asl al-qard) is to be paid off. In other words, shari'a prohibits the stipulation of an excess for the lender, as it amounts to *riba*, whether the excess is expressed in terms of quality or quantity, or whether it is a tangible item or a benefit. However, it is permitted that the repayment of qardh (loan extinguishing) is made with an excess (tangible item, benefit, service, etc), provided that such an excess is neither expressly stipulated nor implicitly pre-arranged (through collusion or tawatu') in the contract of loan.

It is an arrangement whereby a lender lends money to debtor without interest as it amounts to *ribah*. But the debtor can pay extra amount as gift for help but it should not be agreed upon at the time of lending otherwise it will also lead to interest (*ribah*).

6. CONCLUSION

Based upon the above study the following conclusions can be drawn:

- i. Islamic finance is truly based upon the principle of non-acceptance of interest
- ii. There are many ways of finance which can be considered as fair dealing/contract such as mudarbah, qard-al-hassan etc.
- iii. The Islamic banking rules covers almost all and every concept of financing and provides way for each and every finance need.
- iv. Equity shares are acceptable way of Islamic banking as they follow the principles of mudarbah i.e. sharing of profit and losses along with sharing of capital.
- v. Debentures and preference shares are banned in Islam as they involve a fixed interest obligation.
- vi. Operating leases are not acceptable rather financial lease is acceptable in the Islamic banking.

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