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ISLAMIC BANKING

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Interest-free banking

Some financial institutions do not charge interest on loans or pay interest on savings, because it is against certain ethical or religious beliefs. For example, in Islamic countries and major financial centres there are Islamic banks that offer interest-free banking.

Islamic banks do not pay interest to depositors or charge interest to borrowers. Instead they invest in companies and share the profits with their depositors. Investment financing and trade financing are done on a profit and loss sharing (PLS) basis. Consequently the banks, their depositors, and their borrowers also share the risks of the business. This form of financing is similar to that of venture capitalists or risk capitalists who buy the shares of new companies. (See Unit 28)

Types of accounts

Current accounts in Islamic banks give no return – pay no interest – to depositors. They are a **safekeeping** arrangement between the depositors and the bank, which allows the depositors to withdraw their money at any time, and permits the bank to use this money. Islamic banks do not usually grant overdrafts on current accounts. Savings accounts can pay a return to depositors, depending on the bank's **profitability**: that is, its ability to earn a profit. Therefore the amount of return depends on how much profit the bank makes in a given period. However, these payments are not guaranteed. There is no **fixed rate of return**: the amount of money the investment pays, expressed as a percentage of the amount invested, is not fixed. Banks are careful to invest money from savings accounts in relatively risk-free, short-term projects. **Investment accounts** are **fixed-term** deposits which cannot be withdrawn before maturity. They receive a share of the bank's profits. In theory, the rate of return could be negative, if the bank makes a loss. In other words, the capital is not guaranteed.

Leasing and short-term loans

To finance the purchase of expensive consumer goods for personal consumption, Islamic banks can buy an item for a customer, and the customer repays the bank at a higher price later on. Or the bank can buy an item for a customer with a leasing or hire purchase arrangement. (See Unit 24) Another possibility is for the bank to lend money without interest but to cover its expenses with a service charge.

If a business suddenly needs very short-term capital or working capital for unexpected purchases and expenses, it can be difficult to get it under the PLS system. On the other hand, PLS means that bank–customer relations are very close, and that banks have to be very careful in evaluating projects, as they are buying shares in the company.

Conventional banks

- Pay interest to depositors
- Charge interest to borrowers
- Lend money to finance personal consumption goods

Islamic banks

- Give no return on current accounts; share profits with holders of savings accounts and investment accounts
- Share borrowers' profits (or losses)
- Buy items for personal customers with a leasing or hire-purchase arrangement

Match the two parts of the sentences. Look at A opposite to help you.

- 1 The basic feature of Islamic banking
 - 2 Instead of charging and paying interest
 - 3 Depositors in Islamic banks
 - 4 Businesses that borrow from Islamic banks
 - 5 Islamic banks operate in a similar way
- a do not receive a fixed return.
 - b have to share their profits with the bank.
 - c Islamic banks and their customers share profits and losses.
 - d is that it is interest-free.
 - e to venture capitalists who buy companies' stocks or shares.

1d, 2c, 3a, 4b, 5e

Which of the following statements could be made by customers of Islamic banks and which by customers of conventional banks? Look at B opposite to help you.

1

I get 1.5% on my current account and 3% on my savings account.

2

I get a variable rate of return on my savings account, depending on the bank's profitability.

3

If I open a five-year investment account, I won't be able to withdraw my money during this period, but I will receive a share of the bank's profits.

4

They offered me an overdraft of up to one month's salary.

5

If the bank makes a loss I could lose part of my savings.

Customers of Islamic banks: 2, 3, 5

Customer of conventional banks: 1, 4

Make word combinations using a word from each box. Then use the word combinations to complete the sentences below. Look at A, B and C opposite to help you.

investment
service
risk
working

capitalists
capital
charge
account

- 1 All businesses need for everyday purchases and expenses.
- 2 I don't pay interest but the bank adds a to cover its expenses.
- 3 Islamic banks are like the who buy the shares of new companies.
- 4 The bank pays me some of its profits on the money I have in my

investment account
service charge
risk capitalists
working capital

1 working capital
2 service charge

3 risk capitalists
4 investment account