**Lecture 2-Introduction to Islamic Banking :**

Islamic banking, also known as Islamic finance or Shariah-compliant finance, is guided by the principles of fairness, ethical investment, and risk-sharing. It operates in accordance with Islamic law (Shari’ah) principles, which prohibit the collection and payment of interest (riba) and promote the sharing of profit and loss (mudarabah). This means that Islamic banks cannot charge or pay interest on loans, and instead, they make a profit through equity participation, where the bank and the customer share the risk and reward of any investment on agreed terms.

Islamic banking also prohibits investments in activities that are considered haram (forbidden) in Islam, such as gambling, alcohol, and tobacco. This ethical stance ensures that Islamic banks’ investments are socially responsible and in line with Islamic values.

The sources of funds for Islamic banks include capital and equity, transaction deposits that are risk-free and yield no return, and investment deposits that carry the risks of capital loss for the promise of variable returns

**Definitions**

Islamic banking is a banking system consistent with Islamic law (Shari’ah) principles and guided by Islamic economics. In particular,Islamic law prohibits the collection and payment of interest.Generally,it also prohibits trading in financial risk (seen as a form of gambling).It also prohibits investing in businesses considered haram (prohibited,forbidden),such as those selling alcohol or pork.

**Shari’ah** An Arabic word for Islamic law,or the Law of Allah,Shari’ah governs both secular and religious life of devout Muslims. It covers religious rituals and many aspects of day-to-day living,politics,economics,banking,and law.

**Riba** The meaning of this Arabic word is close to the charging of interest,which is forbidden by the Quran.Riba also connotes a loan in which the borrower makes a return to the lender that is more or better than what was borrowed.

**Murabahah** (Cost Plus) Murabahah refers to the sale of goods at a price and includes a mutually acceptable profit margin.The price,other costs,and the profit margin must be clearly stated upfront.As applied to lending,murabahah is a fixed-income loan for the purchase of a real asset (such as real estate or a car),with a profit margin instead of a fixed rate of interest.The bank is not compensated for the time value of money outside of the contracted term (and thus cannot charge additional interest on late payments),however the asset belongs to the bank until the loan is paid in full.The transaction is similar to “rent-toown” arrangements for furniture or appliances.

**Mudharabah** (Profit and Loss Sharing) Mudharabah is an arrangement between a capital provider and an entrepreneur.Profits are shared according to an agreed-upon ratio,but if there are losses,the capital provider must bear them all.The bank is compensated for the time value of its money in the form of a floating rate pegged to the debtor’s profits.

**Ghara**r The underlying principle for the prohibition of gharar,which involves the trading of risk or the sale of something that has not yet been obtained,is that one should not profit from another person’s uncertainty.

**An Islamic bank is an institution which provides banking services i.e. accepting deposits, providing ﬁnancing facilities, etc. in compliance with Shariah principles.**

**Characteristics of an Islamic bank**

**-Ensures all transactions are Shariah compliant i.e.**

**the transactions are free from the elements of interest (riba) as well as other prohibitions in Shariah such as Gharar (excessive uncertainty), Qimar (Gambling), etc.**

**-Ensures to receive deposits and extend ﬁnancing facilities in compliance with Shariah principles.**

**- Provides facilities for Shariah compliant businesses only.**

**Following are some of the main diﬀerences in Islamic and conventional banking**

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|  | **Islamic bank** | **Conventional bank** |
| **Basics** | **All Islamic banking activities comply with Shariah principles** | **Major activities of conventional bank are Shariah non-compliant** |
| **Deposits Structure** | **Islamic banks accept saving deposits on the basis of Mudarabah (proﬁt and loss sharing basis).** | **Major activities of conventional bank are Shariah non-compliant. Conventional banks accept saving deposits on loan (qard) basis which results in interest (riba).** |
| **Customer** | **Islamic banks do not deal with customers whose core business activity is completely Shariah non-compliant** | **Conventional banks can deal with such customers whose core business activity is completely Shariah non-compliant** |
| **Modes of Financing** | **Islamic banks provide ﬁnancing facilities on the basis of Shariah compliant contracts such as Shirkat (Partnership), Sale/Purchase, Ijarah (Rent), etc.** | **Conventional banks extend ﬁnancing facilities through interest (riba) based loans which is prohibited in Shariah.** |
| **Shariah Governance System** | **All ﬁnancial dealings of an Islamic bank are governed through a comprehensive ‘Shariah Governance System’** | **In the absence of a Shariah Governance System, there is no mechanism of a Shariah based supervision of the ﬁnancial dealings of a conventional bank** |

**Islamic Banking Model**

**Banking activities can be categorized as:**

**1. Deposit side**

**2. Financing (Asset) side**

**How an Islamic bank ensures that these two activities are in compliance with Shariah principles?**

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| --- | --- |
| **Deposit Side** | **Asset Side** |
| **Mudarabah Non-interest**  **based loan** | **Partnership Lease/Rent Trade** |

In Islam, a loan (qard) is a non-remunerative contract i.e. it can only be interest-free which is why it cannot form the basis of a business transaction. Therefore, to earn a proﬁt, it is important to use contracts in which remuneration is permissible in Shariah such as Partnership (Shirkat), Lease (Rent), Trade, etc. The use of such contracts is what primarily distinguishes Islamic banking from conventional banking.

**1-Basis of Deposits in Islamic banking**

**Qard (Loan):** This is a transaction in which a thing of value (often money) is given by a lender to borrower for their use. The loan is to be repaid by the borrower on demand of the lender.

It is permissible in Shariah to give a loan. However, it is not allowed to receive any additional gain/beneﬁt on it as it is tantamount to interest (riba) which is impermissible (haram**).**

**Mudarabah:** Mudarabah is a partnership in which one partner invests funds while the other partner manages the work. The proﬁt earned is distributed between them as per a pre-agreed proﬁt sharing ratio. The Investing Partner and Managing/Working Partner are referred to as “Rabb-ul-Maal” and “Mudarib” respectively **.**

In Saving and Term deposits, an Islamic bank works in the capacity of Working Partner (Mudarib) whereas the depositors are Investing Partners (Rabb-ul-Maal). After receiving the deposits on Mudarabah basis, Islamic banks invest them across various Shariah compliant avenues e.g. rental arrangements, commercial partnerships, trading, investments, etc. to earn proﬁt**.**

**2-Modes of Financing in Islamic banking**

**Partnership (Shirkat):** In Islamic jurisprudence (ﬁqh), the term ‘Shirkat’ is used for Musharakah, which means to enter into a partnership. There are two types of Shirkat:

a-**Shirkat-ul-Milk** (Co-ownership of asset): This means co-ownership of two or more persons in an asset without a commercial intentions.

father, two persons jointly purchasing a property for own use, etc.

b-**Shirkat-ul-Aqd** (Partnership in business): This means partnership of two or more persons in a commercial enterprise. In such a partnership, the proﬁt earned is shared as per a pre-agreed proﬁt sharing ratio, whereas, any loss incurred is shared as per investment ratio.

**Currently, Islamic banks oﬀer the following two ﬁnancing products based on Musharakah:**

**1**,Diminishing Musharakah (based on Shirkat-Milk)

2. Running Musharakah (based on Shirkat-ul-Aqd)

**Diminishing Musharakah is generally oﬀered on the basis of Shirkat-ul-Milk. Following are the three legs of a Diminishing Musharakah transaction**:

**-Shirkat-ul-Milk (Partnership**

**-Ijarah (Lease):**

**-Sale of ownership share**

**Trade :** Islamic banks provide ﬁnancing on sale/purchase basis mainly through the following four methods

**1. Murabahah**: Murabahah is a sale transaction in which the seller discloses the cost of goods to the buyer**.**

**2. Tijarah**: In certain cases, customers have ﬁnished goods available with them for onward sale in the market on a credit basis. If such customers require ﬁnancing, bank purchases the ﬁnished goods from them at a discount on cash basis. The bank then appoints the customer as its agent to sell the goods in the market at a proﬁt. This way of providing ﬁnancing facility to customers is generally termed as ‘Tijarah ﬁnancing’

**3. Salam**: Salam is a sale transaction in which the complete sale price is paid in advance by the buyer whereas the commodity is to be provided by the seller on agreed future date. Such sale transactions are permissible in Shariah under certain conditions. Even though the general rules of a sale transaction (i.e. the existence of commodity and the commodity being in ownership/possession of the seller) are not met at the time of entering into a Salam transaction, it has been allowed as an exception to these rules in the light of Ahadith.

**4. Istisna**:Istisna is a sale transactionin which the subject matter is an asset that requires manufacturing. Generally, the buyer gives an order to the seller and the seller manufactures the asset keeping in view the buyer’s requirements. The payment terms can be mutually agreed to be advance, cash, credit or on instalment basis. The asset is manufactured and delivered to the buyer at a later date. In Istisna as well, even though the general rules of a sale transaction (i.e. the existence of asset and the asset being in ownership/possession of the seller) are not met at the time of entering into Istisna contract, it is permissible in Shariah, subject to certain conditions. Therefore, it has been allowed as another exception to these rules in the light of Ahadith**.**