

**GERMANENESS OF ISLAMIC BANKING  
OVER CONVENTIONAL BANKING**  
**Advantages of Islamic Banking over Conventional Banking**

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**ABSTRACT**

*The Qur'an (2:30) says that man was created as the representative of God on earth. This concept has a considerable effect on Islamic business, since the lack of a sense of absolute ownership promotes a sense of working for society, especially the needy. This is not some philosophical concept, removed from the daily life of the society. It manifests itself in all the different aspects of lives. What makes the trader, banker, agriculturist or research and development scientist perform his job to the best of his ability?*

*At the heart of Islam is a sense of cooperation, to help one another according to principles of goodness and piety (but not to cooperate in evil or malice). Islamic economic principles offer a balance between extreme capitalism and communism. It offers the individual the freedom to produce and create wealth, while surrounding the individual with an environment controlled, not by human rulers, but by Divine Guidance for the economy, as enshrined in the Qur'an and the Sunnah (the living example of Prophet Muhammad), which sets moral rules and norms of behaviour that must require the utmost sincerity of intention. When these rules and norms are internalised and acted upon by people, peace and prosperity result for the wider society. In capitalist economies, it is the notion of competition. This involves the necessity to constantly produce more new things for profit to keep up with others and this makes for wastage and often generates unbridled greed. But in an economy based on Islamic principles, the idea of man representing God on earth gives businessmen a feeling of co-operating with others for the good of society as a whole, and for himself also. Thus Quranic guidance enables man to conserve and use prudently all the resources of the earth that God has given mankind.*

*A popular belief persists that Islamic banking is simply an interest-free financial structure. But, in fact, Islamic economics is a complete system of social and economic justice. It deals with property rights, the incentive system, the allocation of resources, economic freedom and decision-making and the proper role of government.*

**KEY WORDS:** *No absolute ownership, Divine guidance, Sincerity of intension, Competition, Cooperation*

### Concepts of Islamic Finance<sup>1</sup> followed in Banking

**1. Trusteeship:** The Qur'an (57:7) emphasises that all the resources of the earth belong to God, the Creator, who has made human beings a trustee for them. Humans are therefore accountable to God for the uses they make of these resources.

**2. Caring attitude:** Care for others tempers self-interest, which is ingrained in human nature. It goes naturally with trusteeship, since, in caring for others, one also serves God, who created all humans.

**3. To produce is a Means of Serving God:** Islam emphasises the duty of every individual to work for his living. Productive enterprise is looked upon as a means of serving God (2:195).

**4. Application of the Shari'ah Rulings to Business:** The aim of the Shari'ah rulings is to make the transfer of goods safe and easy and to facilitate economic transactions by eliminating vagueness or misunderstanding in all types of contracts. It prohibits the charging of interest on loans as a form of injustice.

**5. Mutual Consultation:** Men are free to make private economic decisions, but decisions concerning the public welfare must be based on consultation. The Qur'an describes Muslims as a people "whose rule (in all matters of common concern) is by consultation among themselves."

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<sup>1</sup> Reference  
Wikipedia

(42:39). Mutual consultation avoids society or local communities coming under the rule of a dictator and makes sure that reasonable decisions acceptable to all are made.

**6. Wealth is a Means and not an End:** Islam regards *economic well being* as a means to peace, freedom from hunger and freedom from fear of others, except God. Beyond the satisfaction of basic needs, the ultimate objectives of earning and spending money are moral and spiritual.

**7. Consumer- Protection:** The State should insure that producers, manufacturers and traders do not exploit each other or the buyers. It should curb adulteration, under-weighting, encroachment of thoroughfares, unhealthy trades and unlawful professions and maintain good, firm employee relationships.

**8. Monopolies and Cartels:** No unjust, oppressive or cheating business can be allowed to continue in an Islamic economy.

**9. Zakat or Zakah:** Zakat is a levy on certain categories of wealth. It can be collected and distributed by the government and is obligatory only on Muslims. *Zakat acts as an excellent form of social insurance.*

**10. Qard Hasan:** Qard hasan is a Quranic term meaning an *interest-free loan*.

### **The origin of Islamic banking**

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.

*During the 19th century, several religious scholars argued that the term riba referred to loans for consumption, which people found it difficult to repay, and not to commercial banking loans, where the debtor can repay from the profits.*

When the Muslim world came into contact with the west, Muslims had two choices:

- a) To accept commercial banking, arguing that the interest charged by them did not contain the element of riba prohibited in the Qur'an; or,
- b) To accept that interest charged was riba and try to develop an alternative system of banking.

The ancient Muslim institutions, such as the *Shari'ah courts*, had been made ineffective by the colonial powers. Muslims had no alternative but to work with the colonial institutions, including commercial banking. But the Qur'an makes no distinction between loans for consumption and loans for productive purposes. So their views were rejected. As a consequence, modern commercial banking did not make much headway in Muslim countries and to this day the presents of the conventional framework still dominates the national financial system.

### **The main postulates of Islamic banking**

As we all know that the principle source of the Shari'ah is The Qur'an followed by the recorded

sayings and actions of Prophet Muhammad– the Hadith. Where solutions to problems cannot be found in these two sources, rulings are made based on the consensus of a community learned scholars, independent reasoning of an Islamic scholar and custom, so long as such rulings do not deviate from the fundamental teachings in The Qur'an. It is evident that Islamic finance was practiced predominantly in the Muslim world throughout the middle Ages, fostering trade and business activities. In Spain and the Mediterranean and Baltic States, Islamic merchants became indispensable middlemen for trading activities. It is claimed that many concepts, techniques, and instruments of Islamic finance were later adopted by European financiers and businessmen.

In order to be Islamic, the banking system has to avoid interest. Consequently, much of the literature on the theory of Islamic banking has grown out of a concern as to how the monetary and banking system would function if interest were abolished by law.

1. 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.
2. 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.
3. Another Islamic principle is that **there should be no reward without risk-bearing**. This principle is applicable to both labour and capital. As no payment is allowed to labour unless it is applied to work, so no reward for capital should be allowed unless it is exposed to business risks.

4. **Mudarabah**<sup>2</sup> is the basis of modern Islamic banking on a two-tier basis.

**1st tier:** The depositors put their money into the bank's investment account and agree to share profits with it. In this case, the depositors are the providers of the capital and the bank functions as the manager of funds.

**2nd tier:** Entrepreneurs seek finance from the bank for their businesses on the condition that profits accruing from their business will be shared between them and the bank in a mutually agreed proportion, but that any loss will be borne by the bank only. In this case, the bank functions as the provider of capital and the entrepreneur functions as the manager.

#### **How the Islamic banking is better than conventional banking**

Islamic economics is a complete system of social and economic justice. It deals with property rights, the incentive system, the allocation of resources, economic freedom and decision-making and the proper role of government.

- 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. To ensure compliance to the Shari'ah, Islamic banks use the services of religious boards comprised of Shari'ah scholars.

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#### <sup>2</sup> References

- Mudaraba Explanation by Sheikh Taqi Usmani
- Mudaraba Concept for Islamic banking
- Mudaraba in Syndicated and Structured Finance by SNRDenton

- Islamic finance may be viewed as a form of ethical investing, or ethical lending, except that no loans are possible unless they are interest-free. Among the ethical restrictions is the prohibition on *alcohol and gambling and the consumption of pork*. Islamic funds would never knowingly invest in companies involved in gambling, alcoholic beverages, or porcine food products. Whereas, the conventional banking is mainly interested in profits and not bound in ethics.

Its practitioners and clients need not be Muslim, but they must accept the ethical restrictions underscored by Islamic values.

- The conventional banking system per se is a system of giving loans and accepting deposits at a certain pre-determined rate of interest, difference of which is the earning of the bank or say the institution, where as the Islamic banking is much more than elimination of "Riba" or interest in all its forms because Riba or interest is seen as means of exploitation. In essence, it aims to eliminate not only the exploitation through Riba and to establish a just society by the application of the Shari'ah or Islamic rulings to the operations of banks and other financial institutions.
- In conventional banking western bankers have said that savings and investments would soon dry up if interest were not paid. But this is due to identifying "rate of interest" and not the "rate of return".

*The Qur'an says: "God has permitted trade, but forbidden riba (interest)" (2:275).*

Therefore it is only the fixed, or predetermined, return on savings or transactions that is forbidden, not an uncertain rate of return, such as the making of profit. Hence the Islamic banking do not allow the riba or interest but not against earning profit according to **Mudarabah**. But this practice of accepting rate of return and not a pre-determined rate of interest establishes a complete system of social and economic justice which is absent in conventional banking.

- The idea of trusteeship followed by Islamic banks distinguishes the Islamic approach to economics from materialistic approaches of conventional banks such as extreme capitalism and socialism. It introduces a moral and spiritual element into business life and has been made practicable by creating rules to govern individual behaviour and public policy. Disenchantment with the value neutral capitalist and socialist financial systems led not only Muslims but also others to look for ethical values in their financial dealings and in the West some financial organisations have opted for ethical operations.
- People in the conventional banks who believe that they can increase their wealth through charging others interest and by reducing charitable giving are under an illusion. The wealth and integrity of a society can only increase when the rich give part of their wealth to the needy for no other motivation than to please God. Those who have faith and a vision of their future life like in Islamic banks, understand this.

### **How it has worked**

The revival of Islamic banking coincided with the world-wide celebration of the advent of the 15th Century of Islamic calendar (Hijra) in 1976. At the same time financial resources of Muslims particularly those of the oil producing countries, received a boost due to rationalisation of the oil prices, which had hitherto been under the control of foreign oil Corporations. These events led Muslims' to strive to model their lives in accordance with the ethics and principles of Islam.

When, in the 1960s, Muslim thinkers began to explore ways and means of organising commercial banking on an interest-free basis, economists dismissed their work as wishful thinking.

But, in 1963, in Mit Ghamr, in Egypt, the first Islamic interest-free bank came into being. Mit Ghamr was a rural area and the people were religious. They did not place their savings in any bank, knowing that interest was forbidden in Islam. In these circumstances, the task was not only



to respect Islamic values concerning interest, but also to educate the people about the use of banking.

The following types of accounts were accepted:

- a) Savings accounts
- b) Investment accounts
- c) Zakat accounts

No interest was paid on savings accounts, but withdrawals could be made on demand. Small, short-term, interest-free loans for productive purposes could be made. Funds in investment accounts were subject to restricted withdrawals and invested on the basis of profit-sharing. The zakat account attracted the official amount of zakat.

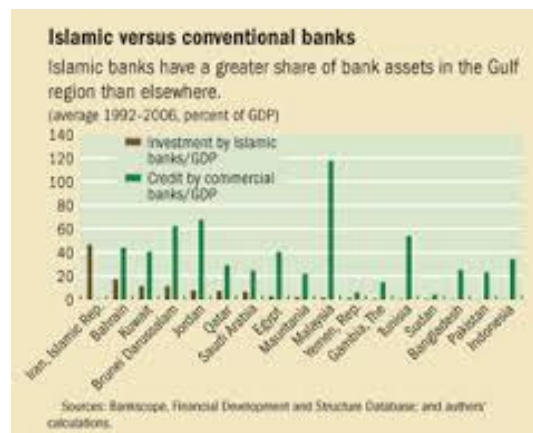
The Mit Ghamr project was successful, as deposits increased from 1963 to 1966. The bank was cautious, rejecting about 60% of loan applications and the default ratio was zero in economically good times. But project was eventually abandoned for political reasons. Nevertheless, it had shown that commercial banking could be organised on a non-interest basis

### **Islamic Banking - Global Trends**

The impressive growth track of Islamic banking over the last few years has created high expectations in the stake-holders and has compelled the major players of the banking industry, investors as well as regulators and government to view it as a separate segment in the banking industry. Keen interest in this discipline has already extended beyond Islamic countries and to non-Islamic financial institutions. In the recent times, the global financial services industry is witnessing a sharp rise in the demand for Islamic financial services. Today, more than 700 Islamic Financial Institutions are operating across the globe with around \$1.2 trillion assets under management in more than 85 countries. Financial Institutions from Middle East, Far East, US

and Europe to Africa, South and Central Asian republics are offering Islamic banking services. The industry is growing at a rate of roughly 15-20% percent per year, and could serve 40 to 50 percent of the world's Muslim population within a decade. According to a recent estimate by Standards & Poor's the market potential for Islamic banks is estimated at \$ 4 trillion.

Recently countries like Oman, Nigeria, Tanzania, Uganda & Maldives have opened their doors for Islamic finance and encouraging new and existing financial institutions to offer Islamic financial services to their customers.



## Findings and conclusion

Some of the challenges that the Islamic banking industry faces today includes:

1. **Lack of awareness and skepticism:** including investors, bankers, regulators, researchers and customers
2. **Shortage of HR personnel:** Being a new industry, a major challenge in its growth is the worldwide shortage of trained Human Resource in Islamic banking and finance.
3. **Limited number of Shariah Scholars:** scholars that create over-reliance and raise questions about Shariah compliance of the institutes involved

4. **Lack of Focus:** efforts should be more focused for New Product Development and Research Solutions for Liquidity Management and creation of Islamic Inter-bank Market
5. **Absence of a separate Regulator:** need of Legal and Risk Management Regulatory framework to cater the specific need of Islamic banking Institutes.

### Conclusion

Islamic banking has proved over time that it is based on firm and sound economic principles and has a good potential for become an alternative system of banking especially in view of the global financial crises. However, there is a need for dedicated research and steps from the governments all over the world to develop a sound legal and regulatory framework for Islamic financial industry. Attempts should be made to modify the existing structure to provide better products and quality service within the ambit of Islamic laws. Interest-based banking has taken hundreds of years to reach this level where it is today, expecting the same from Islamic banking in its nascent stage will be expecting too much. To develop an economic system truly reflective of the sacred principles of Islam, all stakeholders should understand the limitations at this stage and work towards its advancement.

### Suggestions:

Below are some key drivers<sup>3</sup> for growth and competitiveness of Islamic banking industry which must be looked upon by related governments and policymakers to give a boost to Islamic banking.

- I.** Product Innovation, Development and Research
- II.** Flexible and practical application and enforcement of Shariah principles and injunctions and its acceptability by public
- III.** Creation of global financial hubs and regulators' support for Islamic finance industry

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<sup>3</sup> Ahmed Ali Siddiqui, Meezan bank ltd.

- IV. Separate governance and prudential regulations and supervisory guidance for Islamic banks.
- V. Development and adoption of simple, standard and cost effective legal frameworks for contracts associated with the new and hybrid products

**Annexure-1*****ISLAMIC BANKS AND FINANCIAL INSTITUTIONS*****Middle - East****BAHRAIN**

1. **Bahrain Islamic Bank**
2. **ABC Islamic Bank (E.C.)**
3. **Shamil Bank**
4. **Noriba Bank**
5. **Gulf Finance House**
6. **Albaraka Bank Bahrain**
7. **Citi Islamic Investment Bank E.C**
8. **Islamic Investment Bank**
9. **Al-Barka, Bahrain**

**IRAN**

1. **Bank Melli Iran**
2. **Bank Saderat Iran**
3. **Bank Mellat**
4. **Bank Tejarat**
5. **Bank Sepah**
6. **Bank Refah**
7. **Export Development Bank of Iran**
8. **Bank Sanaat o Maadan**
9. **Bank Keshavarzi**
10. **Bank Maskan**
11. **Karafarin Bank**
12. **Saman Bank**

13. **Bank Eghtesad-e-Novin**

14. **Bank Parsian**

#### **JORDAN**

1. **Jordan Islamic Bank**

2. **Islamic International Arab Bank**

#### **KUWAIT**

1. **The International Investor**

2. **Kuwait Finance House**

#### **LEBANON**

1. **Al-Baraka Bank Lebanon**

#### **QATAR**

1. **Qatar Islamic Bank**

2. **Qatar International Islamic Bank**

3. **Qatar Islamic Insurance Company**

4. **Qatar International Islamic Bank**

#### **SAUDI ARABIA**

1. **Islamic Development Bank**

2. **Iciec**

3. **Al Baraka Investment & Development Co.**

4. **Al Rajhi Banking & Investment Corporation**

5. **National Commercial Bank**

6. **Bank Al-Jazeera**

**UAE**

1. **Dubai Islamic Bank**
2. **Abu Dhabi Islamic Bank**
3. **Emirates Islamic Bank**
4. **Noor Islamic Bank**
5. **Al Hilal Bank**
6. **HSBC Amanah**
7. **Sharja Islamic bank**
8. **Badr Al-Islami(Islamic Banking Division of Mashreq Bank)**
9. **Attijari Al Islami(Islamic Banking arm of Commercial Bank of Dubai)**
10. **Islamic International Arab Bank**

**South - East Asia****BRUNEI**

1. **Islamic Bank Brunei Darussalam**
2. **Islamic Development Bank of Brunei (IDBB)**

**INDONESIA**

1. **PT Maybank Indonesia Syariah**
2. **PT Bank Syariah BNI**
3. **PT Bank Jabar dan Banten Syariah**
4. **PT BCA Syariah**
5. **PT Bank Victoria Syariah**
6. **PT Bank Panin Syariah**
7. **PT Bank Syariah Bukopin**
8. **PT Bank Syariah Mega Indonesia**
9. **PT Bank Syariah Mandiri**

**10. PT Bank Syariah Muamalat Indonesia****MALAYSIA**

- 1. Bank Islam Malaysia Berhad**
- 2. Bank Muamalat Malaysia Berhad**
- 3. MNI Takaful**
- 4. Syarikat Takaful Malaysia**
- 5. Bank Islam Malaysia**

**PHILIPPINES**

- 1. Al-Amanah Islamic Bank**

**Indian Subcontinent****BANGLADESH**

- 1. Islami Bank Bangladesh**
- 2. Islamic Finance and Investment Limited**
- 3. Shahjalal Islamic Bank**
- 4. ICB Islamic Bank Limited**
- 5. First Security Islami Bank**
- 6. Social Islami Bank Limited**
- 7. Al-Arafah Islamic Bank**

**INDIA**

(Islamic Banking is not allowed as per the current regulatory system, but these financial institutions claim that they are working as per islamic principles)

- 1. Seyad Shariat Finance**
- 2. Al-Barr Finance House Limited (India)**



3. **Al-Ameen Finance & Investment Corporation**
4. **Parsoli Corporation**
5. **Idafa Investments**

**PAKISTAN**

1. **Meezan Bank**
2. **Dawood Islamic Bank Limited**
3. **Dubai Islamic Bank Pakistan limited**
4. **BankIslami Pakistan Limited**
5. **Islamic Investment Bank Limited, Pakistan**
6. **Al-Baraka Bank Pakistan**
7. **Emirates Global Islamic Bank**

**Africa****ALGERIA**

1. **Banque Al-Baraka d'Algérie**

**GAMBIA**

1. **Arab-Gambian Islamic Bank**

**SUDAN**

1. **Al Baraka Bank**
2. **Faisal Islamic Bank**
3. **Islamic Co-Operative Development Bank**
4. **Omdurman National Bank Sudan**

**SOUTH AFRICA**

1. **Albaraka Bank South Africa**

### **Rest of the World**

#### **TURKEY**

1. **Albaraka Turkish Finance House**
2. **Kuwait Turkish Participation Bank**
3. **Turkiye Finans Participation Bank**
4. **Bank Asya**

#### **UK**

1. **Islamic Bank of Britain**
2. **Dallah Al Baraka**

#### **USA**

1. **Amana Mutual Funds Trust**
2. **American Finance House, LARIBA Bank**
3. **MSI Financial Services Corporation**
4. **Manzil USA**