Bulletin of the *Transilvania* University of Braşov
Series V: Economic Sciences • Vol. 6 (55) No. 2 - 2013

SHARI'AH CONCEPTS IN ISLAMIC BANKING

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Abstract: *The paper analyses the main Shari'ah concepts in Islamic banking, a system which operates in accordance with the Islamic law principles, the most important being the prohibition against the payment or acceptance of interest charges (riba), replaced by profit-and-loss-sharing arrangements(PLS), Mudharabah. Also, the paper presents a survey of the historical evolution of the Islamic banking system in Muslim countries, starting with the first Islamic bank, early in the 60's, Mit Ghamr Local Savings Bank in Egypt. In conclusion, the Islamic banking system is a rapid growth one. It is expected that this presentation will be helpful in increasing the interest in the Islamic principles of banking and financing.*

Key words: Riba, *Islamic Economics, Islamic Banking, Interest.*

1. Introduction

Islamic Banking is restricted to Islamically acceptable transactions, which exclude those involving alcohol, pork, gambling-*maysir* (games of chance involving money), *bayu al-gharar* (speculative trading or trading in risk), engaging in only ethical investing and moral purchasing.

Islamic banking is also known as an interest free banking system, as the Shari'ah disallows the acceptance of *"riba"*.

In the Arabic language, *„riba"*, the literal meaning of interest, also known as *„usury"*, means excess or addition, an effortless profit, the "premium" that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity, a tool of oppression and a means to unjustly take money of other by exploiting their needs and circumstances.

Riba is forbidden in Islamic economic jurisprudence, under Shari'a Islamic law, and considered as a major sin, amongst the Seven Heinous Sins (Believing in gods other than God; Practicing magic; Murder; Riba/usury; Unlawfully taking orphans' money; Running away from the battlefield; Accusing chaste, believing women) [Al-Saba al- Mubiqat].

The term riba is used in the Shari'ah in two senses. The first is *riba al-nasi'ah* (riba in loans, interest charged on money loans), and the second is *riba al-fadl* (riba in excess, interest which is charged in barter transactions of commodities).

Riba al-fadl involves an exchange of unequal qualities or quantities of the same commodity simultaneously, and could therefore be described as the usury of surplus. *Riba al-nasia*, the usury of waiting, involves the non-simultaneous exchange of equal qualities and quantities of the same commodity and does not therefore involve

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a surplus but only a difference in the exchange timing. Some writers employ the term *riba al-nasia* to define such an exchange. [14]

An exchange in which one part with 110 grammes of gold now in return for 110 grammes of gold to be received tomorrow can be described as *riba al-nasia*. An exchange in which one part with 110 grammes of gold now in return for 115 grammes of gold to be received now can be described as *riba al-fadl*.

A typical examples of *riba al-nasi'ah* is when a person owes some money to another person and the period of debt expires, the lender demanding his principal sum; if the debtor expressed his inability to pay, the lender would then grant him an extension on the condition that he paid in excess of the capital. The period is then extended with an increased debt. The additional amount charged was called *riba*.

Other terms that are commonly used for riba in loans are *riba of old times (riba al-jahiliyya), riba of credit, explicit riba* and a price for time.[2]

Riba-al-fadl or riba in excess has two forms:

1. *Riba in Barter Exchange* – it arises when the same variety or two different varieties of the same commodity are exchanged in unequal measures at spot or over a time lag.

2. *Implicit Riba*: it arises when a person lends money without any explicit contractual increase over the principal, but over time he draws some casual or regular favours from his borrower. Such favours may be of negligible money value like a ride on an animal of the borrower, a meal or a gift from the borrower.

Other terms used for riba of excess are *riba in hadith, riba in trade* and implicit riba. [6]

Islam has abolished both types of Riba mentioned above, *Riba al-nasi'ah, Riba-al-Fadl*.

Exploring the Qur'an, there are at least four places where Allah has mentioned *riba* (the interest), in its economic sense:

The first one is in Surah Al-Baqarah verses no.275, 276, 278, 279.

In verse no.2: 275

"Those who devour usury will not stand except as stands one whom the Satan by his touch has driven to madness. That is because they say, "trade is like usury", but Allah has permitted trade and has forbidden usury."[8],

In verse no.2: 276

"Allah will deprive usury of all blessing, and will give increase for deeds of charity, for he does not love any ungrateful sinner."[9]

In verse no.2:278

"Oh you who believe! Fear Allah and give up what remains of your demand for usury if you are indeed believers."[10]

In verse no. 2:279

"If you do not, take notice of war from Allah and his Messenger *sallallahu alaihe wasallm* but if you repent you shall have your capital sums. Deal not unjustly and you shall not be dealt with unjustly."[11]

In the second place in Surah Aal-Imran, verse no.3:130 Allah says:

"Oh you who believe! Devour not usury doubled and multiplied; but fear Allah that you may prosper."

In the third place in Surah Al-Nisaa' Allah says in verse no. 4:161

"That they took *riba* though they were forbidden and they devoured peoples wealth wrongfully; we have prepared for those amongst them who reject faith a grievous punishment."[12]

In the fourth place in Surah Al-Room, verse no.30:39

"That which you give in usury for increase through the property of people will have no increase with Allah: but that which you give for charity seeking the countenance of Allah, it is these who will get a recompense multiplied."

2. Shari'ah concepts in Islamic banking

Islamic banks and banking institutions that offer Islamic banking products and services (IBS banks) are required to establish a Shari'ah Committee (Sari'ah Supervisory Board – SSB), to guide and advise them and to make sure that they function in a manner that is in line with Shari'ah principles (rules and values set by Islam, Arabic meaning, Path or a way, and also decides whether proposals for new varieties of transactions comply with Shari'ah. Shari'a provides guidance and assistance to all aspects of human life including daily routines, politics, clothing, food, sports, amusements, religious and familial obligations of a human and it provides guideline for financial dealings as well).

The common Shari'ah concepts used in Islamic banking include:

Shari'ah concepts in Islamic banking Table 1

Concept	Definition
Wadiah(Custody or safekeeping)	This concept refers to a conventional saving account based on Islamic contract of Al Wadiah, depositing cash or other assets in a bank for safekeeping. The bank guarantees the safety of the items it keeps. The depositor grants the Bank their permission to utilize the money for whatever purpose permitted by Shari'ah. The Bank in return guarantees the value of the deposit thus creating a Wadiah Yad-Dhamanah contract. How it works: 1. The owner (depositor) places money in a bank and the custodian (Bank) guarantees to return the money. 2. The depositor is allowed to withdraw the money anytime. 3. The bank may charge him a fee for looking after his money and may pay *hibah* (gift) to him if it deems fit. 4. This concept is normally used in deposit-taking activities, custodial services and safe deposit boxes.
Mudarabah(Profit-and Loss Sharing, PLS)	Mudarabah is a profit sharing arrangement or financial agreement between two parties: Rabb-al Mal, the capital owner, and Mudarib, an investment manager. The investor will supply the entrepreneur with funds for his business activity and gets a return on the funds he puts into the business based on a profit sharing ratio that has been agreed earlier. How it works: 1. The capital provider supplies funds to the bank (entrepreneur) after agreeing on the terms of the Mudharabah arrangement. 2. The bank invests funds in assets or in projects. 3. The business may make profit or incur loss. 4. The profit is shared between the capital provider and the bank, as entrepreneur, based on a pre-agreed ratio. 5. Any loss will be borne by the capital provider; the loss to the manager is the opportunity cost of his own labour, which failed to generate any income for him. The principle of Mudarabah can be applied to Islamic banking operations in two ways: between a bank (as the entrepreneur) and

	the capital provider, and between a bank (as capital provider) and the entrepreneur.
Bai'Bithaman Ajil(Deferred Payment Sale)	Bai'Bithaman Ajil refers to the sale of goods where the buyer pays the seller after the sale together with a profit margin agreed by both parties. How it works: 1. The buyer picks an asset he would like to buy. 2. Then he asks the bank for BBA and promises to buy the asset from the bank through a resale at a mark-up price. 3. The bank buys the asset from the owner on cash basis. 4. The ownership of the goods passes to the bank. 5. The bank sells the goods, passes ownership to buyer at the mark-up price. 6. The buyer pays the bank the mark-up price in instalments over a period of time.
Musharakah(Joint Venture)	This concept refers to a business partnership between two parties or more, or a joint business venture to make profit. The profits made on the basis of Musharakah are shared on an agreed ratio while losses will be divided based on the equity participation ratio (ratio of funds invested by each partner). This is often used in investment projects, letters of credit, and the purchase of real estate or property.
Ijarah Thumma bai'(Hire Purchase)	Used in financing consumer goods especially motor vehicles. There are two separate contracts involved: Ijarah contract (leasing/renting) and Bai' contract (purchase). Here is how it works: 1. The client picks a car he would like to have. 2. He asks the bank for Ijarah of the car, pays the deposit for the car and promises to lease the car from the bank after the bank has bought the car. 3. The bank pays the seller for the car. 4. The seller passes ownership of the car to the bank. 5. The bank leases the car to the client. 6. The client pays Ijarah rentals over a period. 7. At the end of the leasing period, the bank sells the car to the client at the agreed sale price.
Wakalah(Agency)	It means a contract whereby a person (principal) asks another one to act on his behalf (as his agent) for a specific task. The agent will be paid a fee for his services.
Qard(Rate-free finance)	Finance is given for a fixed period on a goodwill basis and the borrower is only required to repay the amount borrowed. The borrower may pay an extra amount (without promising it) as a way to thank the lender.
Hibah(Gift)	A voluntary payment made (or not made) willingly in return for a benefit received, a token given voluntarily by a debtor to a debitor in return for loan.

Source: Banking Info-Shariah Concepts www.islamic- banking.com/islamic_banking.aspx

3. The beginning of the Islamic banking system.

The mechanisms and concepts of the banking system were implied since the birth of Islam (when the Prophet himself acted as an agent for his wife's trading operations), but the term „Islamic banking" is recent, becoming common in the 1960's.

After the Islamic countries achieved independence following World War II and the renaissance of Islamic sentiment, the idea of creating „Islamic Banks", as „Interest-free Banks", arose.

The present forms of financial transactions used by Islamic banks, such as *mudharabah, musharakah, murabahah, ijarah wa iqtina* are concepts born of the past thinking of religious scholars and jurists.

The Mit Ghamr Local Savings Bank in Egypt, was the first Islamic bank, founded on 25th July 1963 by Ahmad El- Naggar, and even if the project was abandoned for political reasons beyond its control, it is considered the bank which has paved the way for modern Islamic banking. This took the form of a savings bank (after the model of German savings banks, adapted to the rural environment of an Islamic developing country), based on profit-sharing, and until 1967 there were nine more such banks in the country, which neither charged nor paid interest *(riba)*, investing mostly by engaging in trade and industry, directly or in partnership with others, and sharing the profits with their depositors [13]. Thus they functioned in essence as saving-investment institutions rather than as commercial banks. Its role was, first of all, to act as an efficient intermediary between the supply and demand of capital; secondly, as an educational centre for economic efficiency, and thirdly, as a dynamic factor in mobilizing the idle capital for investment. [3]

The Number of Depositors and their Average Deposits in Mit-Ghamr Islamic Savings Banks Table 2

Year	No of Depositors	Growth in %	Average Deposit Per Saver	Growth in %
1964	17,560	-	2.33	-
1965	30,404	73	6.29	170
1966	151,998	400	5.79	-1
1967	251,152	65	7.28	26

Source: El-Naggar, Ahmed A., (1978) "Islamic Banks: A Model and a Challange" in Gauhar (ed.) *The Challenge of Islam,* Economic Council of Europe, London(1978)

Mit-Ghamr Islamic Savings Bank's branches between 1963-1967 Table 3

Branch Name	Opening Date	Branch Name	Opening Date
1 Mit Ghamr	05-07-1963	6 Zefti	09-02-1966
2 Sharbine	14-08-1965	7 Al Mahallah	24-07-1966
3 Al Mansoura	11-09-1965	8 Misr Al-Jadidah	23-07-1966
4 Dakerous	09-10-1965	9 Belqaa	01-10-1966
5 Kasr Al Ayni	14-10-1965		

Ibidem and [4]

As it can be noticed, the bank prospered between 1964 and 1967, the number of depositors increasing rapidly to 251,000 and the deposits growing at higher rates than expected; and so did the, the number of branches, given the loans which were used for purposes like house building and repair, purchase of machinery for handicraft industries (sewing machines, hand-looms for weaving textiles), create an irrigation system etc.

Soon afterwards, following the example of MGIB, many commercial banks started doing business, such as Nasser Social Bank, established in 1971 in Egypt, followed by the Islamic Development Bank (IDB)(In 1974, the Organization of Islamic Countries –OIC established the first Islamic bank.

„At the end of 2011, there are 363 full-fledged Islamic financial institutions and a further 108 conventional financial institutions. The Islamic banking industry currently constitutes only 1,6 percent of the total assets of the 50 largest banks in the world(totalling USD66,2 trillion at the end of 2011), it remains one of the fastest growing segments in the global financial services sector”[5]

Today, there are more than 600 Islamic financial institutions operating in more than 75 countries; the Islamic finance industry has grown at a rate of 15.0% - 20.0% annually over the past decade, and the Islamic banking assets grew from approximately USD150.0 billion in the mid-1990s to USD1,3 trillion in 2012.[5]

4. Conclusions

The term „Islamic Banking” is a very young concept, referring to a system of banking or banking activity that is consistent with the Islamic law, also known as Shariah law, principles and guided by Islamic Economics.

Prohibition of interest is the most distinctive feature and probably the most intensively discussed one of Islamic economics.

Based on religious precepts of the Qur'an/ Sura, most Islamic economists are in favour of alternative methods of funding an interest-based system, these methods involving greater risk taking by donors as compared to conventional loans.

Islamic banks engage in three major services: services rendered by banks on fixed exchange, commission, or discount; and creation and development of funds.

Early in the 60’s, Mit Ghamr Islamic Savings Bank helped and gave hope to the other Islamic banks that the Islamic banking system could be a competitive and profitable one, being the first bank which set general guidelines and come up with new and proper banking terminologies.

Today, Islamic banks reveal that many of them are able to acquire considerable amounts of assets, being qualified for ranking among the Top 100 Arab largest banks.

The Islamic banking industry is not only confined to Muslim majority countries, but also into new territories within Central Asia and Europe.

The most important difference between Islamic and conventional banking is that Islamic banking must follow the Shariah. Islamic banking must also avoid activities such as riba or gharar (excessive uncertainty).

Difference between Islamic and Conventional banking Table 4

Islamic Banking	Conventional Banking
Focus on investment	Focus on lending
Emphasis on soundness of project	Emphasis on ability to repay
Coordination with partners in resource mobilisation	Dependence on borrowing in resource mobilisation
Apply moral criteria in investment	Apply only financial criteria

Source: Guide to Islamic Banking, available at: www.mib.com

There are still many problems that Islamic finance will have to face. Islamic banks must offer banking products and services in accordance with Sharia law, much more competitive, able to satisfy their customers' requirements and demands in order to succeed in this competitive market.

According to Pew Research Centre, there are estimated about 1,6 billion (1.629.072.223) Muslims around the world, means 23.2% of the world's population (7.021.863.029) and will grow at a rate of 25% in 2020 and 26.4% in 2030 of the world's population. In this condition the idea of interest-free banking and Islamic financial services has become increasingly attractive to Muslims across the world.

Shariah-compliant finance remains the fastest-growing area of finance worldwide, with more than 600 Islamic Financial Institutions (IFIs) around the world. Financial institutions practicing Islamic finance, reveal that Sharia-complint assets rose fast by 8.85% from $822 billion in 2009 to $895 billion in 2010, by 7.37% from $1,086 billion in 2011 to $1,166 billion in 2012.

Islamic finance has continued to demonstrate upward growth despite growing pains and a loss of confidence in global financial systems, being less affected by the financial crisis. The global crisis gave Islamic financial institutions an opportunity to prove their inherent stability and resilience characteristics.

Islamic finance has been growing at a rate of 25-30% over the past five years, nearly double the growth rate of conventional banking. According to Top 25 Countries by Shariah-Compliant Assets, Iran is the country with the highest level of Sharia-compliant assets, with assets rose from $154,616.28 billion in 2007 to $314,897.4 billion in 2010.

The largesct centres for Islamic finance remain concentrated in Middle East, including Iran, with a share of 35.7% in total Islamic finance assets, Saudi Arabia, 13.9%, United Arab Emiratea (UAE), 8.7%, Kuwait, 7.3%, Bahrain, 5.3% and Qatar, 4.8%, in addition to Malaysia in Asia, with a share of 12.3%. I OIC (The Organization of Islamic Cooperation), member countries in the Middle East such as Turkey, Sudan, Egupt, Jordan and Syria, Islamic finance industry is developing very quickly. In SSA, Nigeria is stepping up the efforts to capitalize on the Islamic finance industry. Other OIC member countries in Asia such Indonesia, which has the largest indigenous Muslim population, and Bangladesh, each represent around 1% of the global Islamic finance industry.

According to The Banker's 2012 Report on the Top 500 Ialamic Financial Institutions, "Shariah-compliant assets rose by 21.41% from $894bn in 2010 to $1,086bn in 2011" and "Islamic finance has held a compound annual growth rate 18.82% from 2006 to 2011".

In the future, Sharia-compliant assets (SCAs), will become a larger percentage of the overall financial sectors in a number of countries.

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