Islamic Banking System: Need, Dimensions and Function

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Abstracts

The Islamic Banks can do the business without being involved in the forward swaps of the exchange dealings. When we move to borrowing and lending activities, the matters become different. Any extra repayment rather than the original principle in any lending-borrowing relation is considered to be usury. Usury in Islam is considered to be one of the big sins. In Islam, there is no difference between usury as an excessive interest or the so-called legal interest itself. Therefore depositors who in fact are a lender to the bank cannot be allowed to take interest in the Islamic measures; but he can be an investor. The percentage of profit must not be offered the same conditions applied to other investors by receiving a portion of the profit that comes out of the pool of the investment portfolio managed by the bank. The relation with the user of funds is not a borrowing-lending relation; but it has a different type of contractual arrangement. Therefore this paper examines the structure, function and dimensions of an Interest free Islamic bank.

Keyword: Islamic, Islam, Investment, Portfoilo

Introduction

The Islamic Banks are banking institutions that provide the banking services within the boundaries of Islamic principles. As any other bank, an Islamic Bank can operate a Current Account, Savings Account, sell or buy different currencies on spot basis, open a Letter of Credit – advice and confirm or issue a Letter of Guarantee, etc. What the Islamic Bank cannot do is the paying or charging any kind of interest under any name or form. Therefore, Islamic Banks cannot offer a loan against interest or discount a commercial bill or grant any drawing facilities. Further, Islamic banks are not allowed to deal in swaps of different currencies because of the involvement of the interest between the two currencies that are exchanged on forward basis.

The Islamic Banking system draws a clear distinction between services and financing activities. As for the banking services, history gives us numerous examples regarding the development of these services whether it was practiced by organized banking institutions as we have it in our present time, or handled through different methods as the old Sumerians or Babylonians used to do it in their Sacred Temples centuries before Christ. The Islamic religion which spread over most of the old known countries in the 7th and 8th century contains the guidelines as to what is permitted to be done and what is prohibited. Islam as the Muslims believe is the last ring in the chain of God's missions to the human beings. Since the early days of Islam the prohibition of usury was one of the basics of the Muslim society. Before Islam, the heathen Arabs used to lend and borrow on usurious basis in a similar manner as the Jews who were living in Arab peninsula did. Those Arabs also knew a unique kind of partnership where one party provides the capital and the other does the work on the basis of participation in the profit.

Need for the Islamic Banking System

For millions of Muslims, banks are institutions to be avoided. Their Islamic beliefs prevent them from the dealings that involve usury or interest (Riba). Yet Muslims need banking services for many purposes much as anyone else needs, and to finance new business ventures, to buy a house, to buy a car, to facilitate capital investment, to undertake trading activities, and to offer a safe place for savings. For Muslims are not averse to legitimate profit as Islam encourages people to use money in Islamically legitimate ventures, not just to keep their funds idle.

However more than 1400 years after the Prophet, can Muslims find room for the principles of their religion, in this fast moving world? The answer comes with the fact that a global network of Interest Free Banks popularly known as Islamic Banks has started to take shape based on the principles of Islamic finance laid down in the Qur'an and the Prophet's traditions 14 centuries ago. Islamic Banking, based on the Qur'anic prohibition of charging interest, has moved from a theoretical concept to embracing more than 300 Islamic Banks and financial institutions, which operate worldwide in some 38 countries.

Patrons of Islamic Banking and Finance are not confined to Muslim countries but are spread over Europe, the United States, the Far East, South Asia and the Middle East. Assets of Islamic Banks worldwide are estimated at more than US$ 265 billion and financial investments above US$ 400 billion. Islamic Bank deposits are estimated at over US$ 202 billion worldwide with average growth between 10 and 20 percent.

In a Muslim society the need for an Islamic Banking is very important. Any Muslim who knows Arabic could not help thinking of the clear meaning of usury and its results when he reads what is written in the Qu'ran. When a person or a group of people act passively in dealing with their money, the social effect would not be limited to that specific person or group of people only, but it would affect the different sectors in the society. If money was kept at home or deposited in a current account, the national economy would be suffering from the unnecessary increase of the money supply. For a true Muslim, the need for a suitable banking system is very important.

Because money in Islam has a special consideration, it is not allowed to hoard money or spend it without any reason. There is a social responsibility for the use of money and there is also an annual percentage of 2.5 on savings to be spent in charitable purposes according to the categories explained in the Qur'an. Between these two ends, the existence of an Islamic Bank becomes a must. When money is deposited there shall be no hoarding. The investment of such deposits would give the answer for the social responsibility and the profits could help the owners to pay his Zakat (Social Charity Tax). From this point one should conclude that if there was no banking system in the world, there should be an invention of such a banking system which would satisfy the needs of the believers in Islam.

Concept of Islamic Banking

The prefix 'Islamic' before `Bank' is only a kind of distinction as we say the Housing Bank or the Industrial Bank, but this distinction is meant to be directed to the way of doing the business rather than the sector itself. The business of banks can be classified into three categories: Banking

Services, Exchange Dealings, Credit Trade, i.e., borrowing and lending or in other words taking deposits and loans to be invested in lending. As for the banking services there is not much difference between an Islamic Bank and a traditional one.

The L/C's and L/G's, the transfer of money, the collections and the safe deposit are provided in the same manner. The only difference comes when there is a rise of a lending-borrowing relation as in the case of the payment of the bill of exchange drawn under a letter of credit without having a sufficient balance to cover the overdraft. In such a case there is no place for charging interest.

Functions and Dimensions of an Islamic Bank

Islamic Banking or preferably called "Partnership/Profit and Loss Sharing Banking" is an economic and financial system based upon and operated according to the jurisprudence and the rules of the economic and social order of Islam. The founders of most of the Islamic Banks put the set of rules to govern their activities in the form of Articles of Association; statues and bylaws and sometimes under different headings such as objectives; scope of work…etc. The common features and main functions of most of the Islamic Banks are:

Establishing, developing and operating a financial and banking institution conforming to Shari'ah, Helping in establishing and developing capital markets according to Shari'ah and promoting Takaful (insurance) business.

- Supporting studies and research on Islamic Economics, Finance and Banking.
- Promoting business and trade relations among Muslim countries and encouraging trade financing and export-oriented products substitute to imports.
- Financing projects and long-term investments.
- Equity participation and share-holding either in already established and successful companies, or in new ones in various sectors of the economy.
- Financing, managing and up-lifting troubled companies with good potentials and sell them afterwards (Islamic leverage by-out)
- Financing small-scale industries and encouraging artisans and skilled people.
- Issuing Mudharabah bonds and investment certificates to finance public enterprises and to participate in building the infrastructure of the economy along the development plans of the country.
- Contributing to social projects and activities.
- Extending traditional banking services on commission basis.
- Mobilizing deposits and other funds.

As realized from this wide range of objectives, scope of work and instruments used to realize these objectives, scholars have outlined the main dimensions of this type of institutions as follows:

- Development Dimension: has deep roots in the production of various sectors of the economy, and has a wide social impact that focus along the objectives of government development plans.
- Universal Dimension: combining the activities of commercial banks, investment banks (merchant) and social banks. It's in a word an economics institution rather than a financial one.
- Ownership: equity dimension through direct ownership of companies or projects and equity financing.
- Direct Pro-active Dimension: not merely being a financial mediator. This is extended to be a catalyst for a positive social and economic change.
- Social Dimension: Restricting its role not only to investment and financing and subsequently maximizing the profit of shareholders but also balancing the interests of all parties of "social contract" i.e. share-holders, depositors, users of funds-beneficiaries- investors, general public using the services of the bank, and the society at large.

- Legal/Shari'ah Dimension: i.e. exclusive and restrictive functions according to Shari'ah jurisprudence.

Structure of Islamic Banks

The organizational philosophy and consequently the managerial concepts and structures are reflections and practical applications of the overall objectives and ultimate targets of a bank. This is why the organization of an Islamic Bank, reflecting its peculiar characteristics, is by definition not similar to conventional banks. There is no one prototype of organization structure for an Islamic Bank, because of following:

- Different legal and administrative regulations in different locations and regions
- Professional and practical requirements in a given banking society,
- The possible size and complexity of operations and market.

Despite these sources of diversity, it is, however, possible and desirable to describe the main features of the organization structure based on the main functions of Islamic Banks. The organization structure will be based on the following main divisions. Highlighted below are the main functions of these divisions:

Banking Operations: The main point of departure here is the types of deposits and investment accounts, they are required to receive different treatments based on profit/loss as compared to the interest based deposits of conventional banks.

Investment and Financing: This includes short term, medium and long-term financing diminishing/decreasing or permanent partnership, equity participation and the like. Here, we notice the diversity of products and the need for extensive experience in all fields and especially financial analysis, economic and social feasibility studies and most important opportunity/project identification. Checking customers and partners accounts and finances play an essential role here.

Legal and Fiqhi Jurisprudence: The implication of medium-long term financing; project-financing and equity participation put tremendous effort and responsibility on the shoulders of the legal department towards documentation and legal structures of partnerships or deals. The Shari'ah jurist is the main vehicle to evaluate, approve contract documents and supervise all operations of the bank in conformity with its objectives and ultimately with principles of Islamic laws.

It is the absolute responsibility of the legal or any related department to observe and maintain these rules and regulations. It is as well the due obligation of the legal/Shari'ah advisor to monitor and check transactions on random basis. All types of new contracts have to be reviewed and agreed upon by him. A general statement of the Shari'ah/legal advisor should be issued to the general shareholders meeting in connection with the annual audited accounts of the bank, certifying conformity to Shari'ah rules and accepted Shari'ah interpretations and practices. This, of course, implies special manpower requirement with the needed qualification and experience.

Financial Control: This function doesn't differ from any conventional bank except in the following two main directions:

- The Islamic Bank is a universal bank with equity participation in subsidiaries, sister companies and the like. This means that the final shape of the balance sheet should be like that of a holding type company to reflect the true picture of the whole set of operations and involvements;
- The chart of accounts and details of accounting principles applied are different from those of a conventional bank which has to be observed, maintained and developed. It requires exceptional qualities of personnel as well.

Administration (including Training and O & M): As stated earlier, since the organizational set-up is different, the criterion of selection and the details of qualification of staff are therefore also quite different from a conventional bank. Though standard rules apply here as well. As for training, this aspect relates to types and quality of staff needed to perform the peculiar kind of functions which require initial and on-going training not only in the disciplines of Islamic Banking and the mission oriented jobs, but also the continuous development of products and instruments based on Shari'ah rules. Quality of the chief executive and Board members makes no exception. In fact there is a huge moral and professional responsibility on the Boards of such banks.

Planning, Research and Development: Planning function is principally the same as in conventional banks with two exceptions:

- It includes planning of complex and sophisticated product mix and activities;
- It includes planning for the bank including subsidiaries and (to a certain extent) associated companies and projects as a holding structure. Business ethics of Islam should be taken into consideration.
- Research and development covers many areas including:
- Collecting economic research and statistics;
- Studying trends and developments to identify prospective opportunities in sectors, projects or markets;
- Marketing research on products/customers (investors, partners and depositors);
- Developing services and conventional products, as well as new products in conformity with Shari'ah rules in coordination with similar banks in a dynamic and continuous way.

Control: This includes internal audit, follow-up and evaluation of projects and equity participation, and the external audit:

Internal audit: It doesn't differ from the traditional elements applicable in any bank. The only difference being in the details of operations have to be considered while auditing. The extra qualification of staff in Shari'ah disciplines is required.

Follow-up and Evaluation: Since the bank has this multiple function of financing, long-term/ partnership investment and equity shareholding, it requires special emphasis and certainly special qualification of staff and system in

- Follow-up and evaluation plans for projects;
- Institutional control measures to monitor and guide the activities of subsidiaries and sister companies to safeguard the "investors" interest.

External Audit: This function by and large doesn't differ from the generally accepted rules. Some differences, however, may appear in respect of the following:

- Qualification of the external auditor in this type of banking and its implications;
- The kind of statements he makes by the end of the year taking into consideration not only to safeguard the interest of stockholders, but also the depositors being effective partners with the bank and affected directly by the performance of the management.
- Conformity with the accepted rules of Islamic Accounting Principles and Practices as adopted by similar banks.

A close liaison should be developed between the external auditors (representing the shareholders) and the legal/Shari'ah advisors (representing the jurisprudence). It is important to note that the legal/Shari'ah Advisor is sometimes appointed directly the shareholders meeting.

Social Activities and Community Services: Apart from the financing and investing activities and extending banking services, the bank should be actively involved in the social activities and community services, such as:

- Establishing and/or managing social funds;
- Contributing to social activities in various forms such as gifts, contributions, promotion of business and social ethics, social research etc;
- Collecting and managing Zakat, Hajj and Umrah funds;

- Encouraging labour-intensive projects and enterprises, individual initiatives of entrepreneurs and promoting venture-capital investments, thus relieving the burdens of employment from the shoulders of the public sector.
- Extending benevolent loans for the general public or for charity without return.

Conclusion

The Islamic Banks can do the business without being involved in the forward swaps of the exchange dealings. When we move to borrowing and lending activities, the matters become different. Any extra repayment rather than the original principle in any lending-borrowing relation is considered to be usury. Usury in Islam is considered to be one of the big sins. In Islam, there is no difference between usury as an excessive interest or the so-called legal interest itself. Therefore depositors who in fact are a lender to the bank cannot be allowed to take interest in the Islamic measures; but he can be an investor. The percentage of profit must not be offered the same conditions applied to other investors by receiving a portion of the profit that comes out of the pool of the investment portfolio managed by the bank. The relation with the user of funds is not a borrowing- lending relation; but it has a different type of contractual arrangement.

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