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Islamic Banking System: A Critical Review

Prof. Somesh Kumar Shukla[1], Dr. Guncha Fatima[2], Dr. Syed Mohammad Ali Rizvi[3]
1 Ex.Dean, Faculty of Commerce University of Lucknow, Lucknow.
2 Assistant Professor, Kalicharan P.G. College Lucknow.
3 Assistant Professor, Unity P.G. College Lucknow.

Abstract

A Bank is the establishment for the custody of money, which receives deposits from public for the purpose of on-lending. A Bank would normally pay Interest on its Deposits and charge interest on all the Advances; and the spread between lending rates and borrowing rates forms the core income of a Bank. In Islamic Banking the Interest is being strictly prohibited in Islam and hence there can be no banking system in Islam based on Interest or Riba that we called is Islamic word. Islamic Banking has the same purpose as conventional banking except that it operates in accordance with the governing rules of Shari'ah. This paper throws light on the Islamic laws, its concepts and governing principles regarding various instruments and operations of Islamic Banking.

Keywords*: Islamic banking, Shariah, Riba, Conventional Banking.*

Introduction

The banking system is the lifeline of any modern economy which helps in the financial intermediation by mobilizing deposits and disbursement of credit. Banking in a modern sense is the process of accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawals by cheque, draft, order or otherwise. The principal function of a Bank is to bring into a common fund or pool of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise. For the purpose of making advances to others, to gain a return in the form of interest, fee and dividends in making advances and providing services to others. Interest being the cogwheel of the modern banking, is strictly prohibited in Islam and hence there can be no banking system in Islam as Interest. An Islamic bank is a financial institution which identifies itself with the spirit of Shariah, as laid down by the Holy Qur'an and Sunnah, as regards its objectives, principles, practices and operations. The veterans of Islam propose that a sound system of Banking is possible in Islam which should be based on the concepts of Mudharaba, Murabaha and Profit and Loss Sharing (PLS). 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 The modern Islamic Banks have positioned themselves sustainably into a fully fledged Interest-free system with a range of competitive products to offer so as to compete with the Modern Interest based Banking system. Besides their range of equity, trade-financing and lending operations, Islamic banks also offer a full spectrum of fee paid retail services that do not involve interest payments, including checking accounts, spot foreign exchange transactions, fund transfers, letters of credit, travelers' cheques, safe-deposit boxes, securities safekeeping investment management and advice, and other normal services of modern banking.

Objectives of study:

- To explore the basic principles and concept of Islamic Banking.
- To understand the challenges for Islamic Banking in India.

Research Methodology:

In this paper the data have been collected from secondary data such as from Journals, Magazine, news paper etc.

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Islamic Banking Concepts

Islamic Society in its real sense is an association for the purpose of harmonious co-existence. The actions of individuals in the Islamic society should carry on the code of moral values and conduct. Islamic society is thus, based upon righteousness and mutual.

Islamic Jurisprudence, in particular, prohibits all such transactions in which some or all of the following components are present:

1. Wadiah Yad Dhamanah (savings with guarantee)

Refers to goods or deposits, which have been deposited with another person, who is not the owner, for safekeeping. As wadiah is a trust, the depository becomes the guarantor and, therefore guarantees repayment of the whole amount of the deposits, or any part thereof, outstanding in the account of depositors, when demanded. The depositors are not entitled to any share of the profits but the depository may provide returns to the depositors as a token of appreciation.

2. Mudharabah (profit-sharing)

Refers to an agreement made between a capital provider and another party (entrepreneur), to enable the entrepreneur to carry out business projects, based on a profit sharing basis, of a pre-agreed ratio. In the case of losses, the losses are borne by the provider of the funds.

3. Musyarakah (joint venture)

Refers to a partnership or joint venture for a specific business, whereby the distribution of profits will be apportioned according to an agreed ratio. In the event of losses, both parties will share the losses on the basis of their equity participation.

4. Murabahah (cost plus)

Refers to the sale of goods at a price, which includes a profit margin as agreed to by both parties. Such sales contract is valid on the condition that the price, other costs and the profit margin of the seller are stated at the time of the agreement of sale.

5. Bai' Bithaman Ajil (deferred payment sale)

Refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties.

6. Bai' al-Dayn (debt trading)

Refers to debt financing, i.e. the provision of financial resources required for production, commerce and services by way of sale/purchase of trade documents and papers. Only documents evidencing real debts arising from bona fide merchant transactions can be traded.

7. Bai' al-Inah

The financier sells an asset to the customer on a deferred payment and then the financier immediately repurchases the asset for cash at a discount.

8. Al-Ijarah Thumma al-Bai' (leasing and subsequently purchase)

Refers to a Al-Ijarah (leasing/renting) contract to be followed by Al-Bai (purchase) contract. Under the first contract, the hirer leases the goods from the owner at an agreed rental over a specified period. Upon expiry of the leasing period, the hirer enters into a second contract to purchase the goods from the owner at an agreed price.

9. Ijarah (leasing)

Refers to an arrangement under which the lessor leases equipment, building or other facility to a client at an agreed rental against a fixed charge, as agreed by both parties.

10. Qardhul Hassan (benevolent loan)

Refers to an interest free loan. The borrower is only required to repay the principal amount borrowed, but he may pay an extra amount at his absolute discretion, as a token of appreciation.

11. Bai' as-Salam (future delivery)

Refers to an 'agreement whereby payment is made in advance for delivery of specified goods in the future.

12. Bai' al-Istijrar (supply contract)

Refers to an agreement' between the client and the supplier, whereby the supplier agrees to supply a particular product on an on going basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment.

13. Kafalah (guarantee)

Refers to a contract of guarantee by the contracting party or any third party to guarantee the performance of the contract terms by contracting parties.

14. Rahnu (collateralised borrowing)

Refers to an arrangement whereby a valuable asset is placed as collateral for debt. The collateral may be disposed in the event of default.

15. Wakalah (nominating another person to act)

Refers to a situation, where a person nominates another person to act on his behalf.

Principles of Islamic Banking

An Islamic Bank is based on the Islamic faith and must stay within the limits of Islamic Law or the sharia in all of its actions and deeds. The original meaning of the Arabic word sharia was 'the way to the source of life' and it is now used to refer to legal system in keeping with the code of behaviour called for by the Holly Qur'an. Four rules govern investment behaviour:

1. The absence of interest-based **(riba)** transactions;

2. The avoidance of economic activities involving speculation **(Gharar)**;

3. The introduction of an Islamic tax, **(zakat)**;

4. The discouragement of the production of goods and services which contradict the value pattern of Islamic **(haram).**

1. Riba

Perhaps the most far reaching of these is the prohibition of interest (riba). The payment of riba and the taking as occurs in a conventional banking system which is prohibited by the 'Holy Qur'an, and thus investors must be compensated by other means. Technically, riba refers to the addition in the amount of the principal of a loan according to the time for which it is loaned and the amount of the loan.

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In banning riba, Islamic seeks to establish a society based upon fairness and justice (Qur'an 2.239). A loan provides the lender with a fixed return irrespective of the outcome of the borrower's venture. It is much fairer to have a sharing of the profits and losses.

Hence, what is forbidden in Islamic is a predetermined return. The sharing of profit is legitimate and that practice has provided the foundation for Islamic banking.

2. Gharar

Another feature condemned by Islamic is economic transactions involving elements of speculation, Gharar. Buying goods or shares at low and selling them for higher price in the future is considered to be illicit. Similarly an immediate sale in order to avoid a loss in the future is condemned. The reason is that speculators generate their private gains at the expense of society at large.

3. Zakat

A mechanism for the redistribution of income and wealth is inherent is Islam, so that every Muslim is guaranteed a fair standard of living, nisab.' An Islamic tax, Zakat (a term derived from the 'Arabic zakat, meaning "pure") is the most important instrument for the redistribution of wealth. This tax is a compulsory levy, one of the five basic tenets of Islam and the generally accepted amount of the zakat is one fortieth (2.5 per cent) of Muslim's annual income in cash or kind from all forms of assessed wealth exceeding nisab.

Every Islamic Bank has to establish a zakat fund for collecting the tax and distributing it exclusively to the poor directly or through other religious institutions. This tax is imposed on the initial capital of the bank, on the reserves, and on the profits as described in the Handbook of Islamic Banking.

4. Haram

A 'strict code of 'ethical investment' operates. Hence it is forbidden for Islamic Banks to finance activities or items forbidden in Islam, haram, such as trade of alcoholic beverage and pork meat.

Furthermore, as the fulfilment or materials needs assures a religious freedom for Muslims, Islamic Banks are required to give priority to the production of essential goods which satisfy the needs of the majority of the Muslim community, while the production and marketing of luxury activities, israf wa traf is considered as unacceptable from a religious viewpoint.

Major issues and challenges of Islamic banking system in India:

1. Banking Without Interest: One of the biggest challenges for 'Islamic Banking in India is that to establish the 'banking without interest' system which works on Islamic law(*sharia).* The officials of RBI say that their banking laws are fully against sharia based banking system. As India is one of the secularist nations strictly prohibits the operation of Islamic banks by regnant banking regulation Act of 1949.

Certain provisions regarding this are mentioned below:

'* Section 5 (b) and 5 (c) of the Banking Regulation Act, 1949 prohibit the banks to invest on Profit Loss Sharing basis -the very basis of Islamic Banking.

* Section 21 of the Banking Regulations Act requires payment of Interest which is against Sharia.'

2. Lack of Specialists: Lack of specialists in Islamic finance is another big challenge for Islamic banks in India. As most of the Islamic financial institutions in our country recruiting their staff from conventional banks which are mostly on the basis of experience but are not expertise in Islamic finance. Due to this they are unable to provide better service to their customer because of lack of knowledge in Islamic finance. These bankers are neither awareness in shariah

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laws nor have knowledge in Arabic. So for this study program or training program in Islamic banking for these bankers are required which is costly.

3. Financial Products are Interest Based: A bank licensed by the RBI becomes part of the monetary system, which means it can create money by deposit generation through deposit acceptance. Since these assets are interest based, Islamic bank cannot hold them.

4. Inability to Maintain Capital Adequacy: Another challenge is the inability to maintain capital adequacy and would be unable to interact with interest based banks and money market in India.

5. Inability to Evaluate Projects: Islamic banking concentrates more on short-term and medium-term operations because long-term lending involves project appraisals and assessing long term profitability. Due to this most of the banks are ill to equipped this responsibility because of the smallness of their operations.

6. Not Possible under the Present Legal Framework: Islamic Banking cannot be offered by Indian banks as well as the overseas branches of local banks under the present legal framework. Except a basic offering like current account, almost no other banking product in India can be modified to meet the conditions of Islamic Banking.

7. Tax Procedures: Another important consideration is the tax procedures. While interest is a passive income, profit is defiantly an earned income which is treated differently. If principles of Islamic Banking are incorporated then how does it comply with the tax procedure is the moot question. Furthermore RBI cannot act as the lender to such banks because such accommodation by the monetary authority is also interest based.

8. **Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) requirements:** Through this there will be less demand in the shine of Islamic banking are the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) requirements. These together eat up about 30 percent of the banks' total deposits. Adding to this priority sector lending leaves banks with very little capital, which they can invest in earning non-interest income.

Difference between Traditional Banking and Islamic Banking:

Table 1

S.No.	Traditional Banking	Islamic Banking
1.	The functions and operating modes are based on fully man made principles.	The functions and operating modes are based on the principles of Islamic Shariah.
2.	It aims at maximizing profit without any restriction.	It also aims at maximizing profit but subject to Shariah restrictions
3.	It can charge additional money (penalty and compound interest) in case of defaulters.	This type of banking has no provision to charge any extra money from the defaulters. Only small amount of compensation is charged and these proceeds are given to charity.
4.	Lending money and getting it back with compound interest is the fundamental function of the Traditional bank.	Participation in partnership business is the fundamental function of the Islamic banks.
5.	The investor is assured of a predetermined rate of interest.	It promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).
6.	Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations.	Since it shares profit and loss, the Islamic banks pays greater attention to developing project appraisal and evaluations.

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7.	The status of a Traditional Bank, in relation to its clients is that of creditor and debtors.	The status of Islamic Bank in relation to its clients is that of partners, investors and trader, buyer and seller
8.	Traditional Banking practices are concerned with elimination of risk when involve in any transaction.	Islamic banking practices are concerned with risk bearing when involved in any transaction.
9.	It does not deal with Zakat (Islamic Tax)	In the modern Islamic Banking system, it has become one of the service-oriented functions of the Islamic Banks to be a Zakat Collection Centre and they also pay out their Zakat.
10.	When Traditional Banks involve in transaction with consumer they do not take the liability only get the benefit from consumer in form of interest.	Islamic Banks bear all liability when involve in transaction with consumer. Getting out any benefit without bearing its liability is declared Haram in Islam

Conclusion:

Islamic Banking or Interest-Free Banking is not some alien concept, it is very well practicable and coherent as to be accepted as an alternative to the Conventional Interest based system of banking. It however, needs a serious thought from all the corners to put it into practice; Willingness on part of Consumers, Intensive Efforts by Banks and suitable and favourable norms (and legalities) by the regulators. Considering such steps to be taken across board, and if really Islamic banks succeed in demonstrating a practical example of socio-economic justice by gradually enhancing their Interest-free Financing and also achieve further satisfactory operational results, there is no reason why this mechanism cannot be accepted as a sustainable mode of Banking worldwide.

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Corresponding Author:
Dr. Guncha Fatima
Assistant Professor,
Kalicharan P.G. College Lucknow.