

# Islamic banking: another kind of banking

By Rym Ghazal

Once considered a “special” and limited type of banking, Islamic banking has now become common, and has grown phenomenally over the past years as a viable alternative to conventional banking. Academix examines what Islamic banking means and what the most recent developments are in this special form of banking.



## Basic Principles of Islamic banking

An Islamic bank is based on the Islamic faith and works within the limits of Islamic Law (Sharia) in all of its actions and deeds. Four rules govern Islamic banking:

- the absence of interest-based (riba) transactions;
- the avoidance of economic activities involving speculation (ghirar);
- the use of an Islamic tax, zakat; (to be distributed to the Islamic treasury and then passed on as charity to the less fortunate);
- the discouragement of the production of goods and services which contradict the value pattern of Islamic Law (haram)

What conventional banks and experts once called a “dream” and “unprofitable” has over the past two decades become a budding reality with Islamic banking now accepted worldwide as an ethical and viable financial system.

Islamic banking, in its simplest form, refers to a system of banking that is consistent with Islamic Law (Sharia), where in particular the collection of interest, also commonly known as “riba” in Islamic discourse, is prohibited.

Currently, Islamic banks manage funds of over \$200 billion, grabbing the lion's share of business in key markets such as the Gulf, with some Western banks also starting Islamic operations.

“Growth accelerated after the 2001 attacks on the United States. We used to see Islamic banks with \$40-\$70 million capital each; now we hear of \$1 billion and more,” said Izzedine Khojah, secretary general of the General Council for Islamic Banks in a recent interview with the media during the 2006 Islamic Banking conference.

There are an estimated 300 Islamic banks and financial institutions worldwide holding \$300 billion in assets, which is predicted to grow to \$1 trillion by 2013, according to various financial reports.

## Islamic vs. Conventional banking

Islamic banking represents a radical departure from conventional banking due mainly to the lack of interest charges. An Islamic bank cannot charge any fixed return in advance, but rather operates by sharing profits or losses between the bank and its clients.

Under the system, a bank works closely with clients on financing matters, such as jointly setting up projects with the aim of selling them to third parties.

Unlike a conventional bank, which is basically a borrower and lender of funds, an Islamic bank is essentially a partner with its depositors on the one side, and also a partner with entrepreneurs on the other when employing depositors' funds in productive direct investment.

Depositors in an Islamic bank also share in profits according to a predetermined ratio, and are rewarded with profit returns for assuming risk.

Since Islamic banking is based on the Sharia - which means "the way to the source of life" - investments in the liquor, wine, casino, pornography, gambling and pork processing industries are prohibited, along with forbidding Muslims from accepting or paying interest - a challenge for Western banks that are based on the interest-accrual system.

"Islamic banking has proved the ideal model for the needs of Islamic societies; we are no longer talking about fragments. Governments and central banks have taken the lead in supervising Islamic banks and encouraging growth of the system," said Khojah.

#### **Islamic banking spreads within the Middle East & beyond**

Recently, Syrian Deputy Prime Minister for Economic Affairs Abdullah Al-Dardari announced that 2006 "will witness the opening of several Islamic banks in Syria for the first time."

Syrian President Bashar Al-Assad had issued a decree to grant licenses for Arab banks and financial institutes to establish Islamic banks in the country, with a minimum capital of \$100 million.

Lebanon, a regional deposit magnet for decades, passed similar laws a few years ago, although conventional banks still dominate the system.

One doesn't have to be a Muslim to work or deal with an Islamic bank. In Malaysia, for example, 70% of the country's Islamic banking customers are non-Muslim.

For those working within the Islamic banking system, it has been repeatedly stated that employees must follow "an Islamic framework," but not necessary be Muslims.

One head of an Islamic bank summarized the general policy as being based on the fact that "customers must feel that they are entering a sacred place where the use and employment of capital will be acceptable and satisfactory to God."

Fast growth however has not been without drawbacks, with financiers criticizing the Islamic model as lacking internal competition and offering clients similar returns when the normal practice is to encourage diversity.

"There are definitely challenges. Conventional banking has been around for four centuries and we are only three decades old," Khojah said.

"The objective of Islamic banking was to prove itself," he said.

So what is the next step for Islamic banks? According to Khojah, "to expand even further and improve quality of services, seek specialization and come up with new products at lower cost."

