3.1 Islamic Banking Concepts

Islami Bank is a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operation. For millions of Muslims, banks were institution to be avoided. Islam is a religion, which keeps Believers from the tellers' window. Their Islamic beliefs prevent them from dealings that involve usury or interest (Riba). Yet Muslim needs banking services as much as anyone and for many purposes: to finance new business ventures, to buy a house, to facilitate capital Investment to undertake trading activities and to offer safe place for saving. Muslims are not averse to legitimate profit as Islam encourages people to use money in Islamic ally legitimate ventures not just to keep their funds idle.

However in this fast moving world more than 1400 years after the Prophet (S.A.W) can Muslims find room for the principles of their religion? The answer comes with the fact that a global network of Islamic banks investment house and other financial institution have started to take shape based on the principals of Islamic finance laid down in the Quran and the Prophet's traditions some 14 centuries ago. Islamic banking based on the Quranic prohibition of changing interest has moved from a theoretical concept to embrace more than 100 banks operating in 40 countries with multibillion-dollar deposits worldwide. Islamic banking is widely regarded as the fastest growing sector in the Middle Eastern financial services market. Exploding onto the financial scene barely thirty years ago an estimated $US100 billion worth of funds are now managed according to Shariah.

The definition of Islamic Bank, as approved by the General Secretariat of the OIC - "An Islamic Bank is a Financial Institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operation."

The best-known feature of Islamic Banking is the prohibition on interest. The Holy Quran forbids the charging of 'Riba' on money lent. It is important to understand certain principles of Islam that underpin Islamic finance. Muslim scholars accepted the word 'Riba' to mean any fixed or guaranteed interest payment on cash advances or on deposits. The rules regarding Islamic finance are quite simple and can be summed up as follows:

- The predetermined payment over and above the actual amount of principal is prohibited.
- The lender must share in the profits or losses arising out of the enterprise for which the money was lent.
- Making money from is not Islamic ally acceptable.
- Ggharar (Uncertainty, Risk or Speculation) is also prohibited.
- Investment should only support practices or products that are not forbidden.

3.2 Objectives of Islamic Banking

The objective of Islamic Banking is not only to earn profit but also to do good and welfare to the people. Islam upholds the concept that money, income and property belong to ALLAH and this wealth is to be used for the good of the society. The main objectives of Islamic Banking are as follows:

- To conduct interest free banking.
- To establish participatory Banking instead of Banking on debtor-creditor relationship.
- To invest through different modes permitted under Islamic Shariah.
- To accept deposits on profit-loss sharing basis.
- To establish welfare oriented Banking System.
- To extend operation to the poor, helpless and low income group for their economic enlistment.
- To contribute in achieving the ultimate goal of Islamic economic system.
- To create new entrepreneurs and to arrange required finance them.

3.3 Evolution of Islamic Banking

Islamic Banking comes into reality through a long theoretical exercise of several renowned Islamic scholars and economists. The first attempt to establish an Islamic financial institution took place in Pakistan in 1950. In the modern world, the pioneering role in establishing the first Islamic Bank in 1963 named 'Mit- Ghamar' Saving Bank in Egypt at rural area of Nile Delta. As on today, there are many Islamic financial institutions operating through out the world covering both Muslim and non-Muslim countries of various socio-economic environment.

The first Islamic bank in Malaysia was established in 1983. In 1993, commercial banks, merchant banks and finance companies were allowed to offer Islamic banking products and services under the Islamic Banking Scheme (IBS). These institutions however, are required to separate the funds and activities of Islamic banking transactions from that of the conventional banking business to ensure that there would not be any co-mingling of funds.In Malaysia, the National Syariah Advisory Council additionally set up at Bank Negara Malaysia (BNM) advises BNM on the Shariah aspects of the operations of these institutions, as well as on their products and services.

3.4 Legitimate Business Contracts for Islamic Banks

The modes of mobilization in Islamic banks have derived from the overall permissible contracts in Islam. In what follows we fast describe the concept of Aqd or contract form business perspective and then discuss the legitimate forms contracts that can be used in Islamic banks for both deposit collection and their profitable employment.

A business contract can be defined as the exchange of a thing of value by another thing of value with mutual consent. There are four element of an Aqd or contract:

- Contract (Aqd).
- Subject Matter (Mabe'e).
- Price (Thaman).
- Prossession of delivery (Qabdh).

3.5 Common practices of Islamic banks in mobilization of funds

3.5.1 Current Accounts

All Islamic banks operate current account on behalf of their client individuals and business firms. These accounts are operated for the safe custody of deposits and for the convenience of customers. There is little different between conventional banks as far the operation of current accounts is concerned. There are two dominant views about current account. One is to treat demand deposit as amnah (trust). A trust deposit is defined by the Jordan Islamic Banks as “cash deposits received by the bank where the bank is authorized to use the deposits at its own risk and responsibility in respect to profit or loss and which are not subject to any conditions for withdrawals or depositing”.

3.5.2 Saving Account

All Islamic banks operate saving accounts. It must be pointed out that any return on capital is Islamic ally justified only if the capital is employed in such a way that it is expected to a business risk. Savings accounts at Islamic Banks Generally operate as follows:

- Savings accounts are opened with the condition that deposits provide the bank with an authorization to invest.
- Depositors have the right to deposit and withdraw funds.
- The profits in savings accounts are calculated on the minimum balance maintained during the month. Depositors participate in the profits of savings accounts with effect from the beginning of the month following the month in which the deposits are made. Profits are not calculated with effect from the beginning of the month in which a withdrawal is made from the account.
- A minimum balance has to be maintained in order to qualify for a share in profit.

3.5.3 Investment Deposit

Investment deposits are Islamic banks counterparts of term deposits or time deposits in the conventional system. They are also called profit and Loss-Sharing (PLS) Accounts or Participatory Account. However they can be distinguished from traditional fixed term deposits in the following manner:

- Fixed term deposits in the conventional system operate on the basis of interest while investment accounts in Islamic banks operate on the basis of profit sharing Instead of promising depositors a predetermined fixed rate of return on their investment the bank tells them only the ratio in which it will share the profits with them.
- While fixed term deposit are usually distinguished from each other on the basis of their maturities investment deposits can be distinguished on the basis of maturity as well as on the basis of purposes as it is possible to give special instructions to the bank to invest a particular deposit in a specified project or trade.

The main distinguishing characteristics of investment deposits can be described as follows:

- Deposit holders do not receive any interest. Instead they participate in the share of the profits or losses.
- Usually these accounts are opened for a specific period e.g. three months, six month, one year or more.
- The return on investment is determined according to actual profit s from investment operations of the bank and shared in an agreed proportion by depositors according to the amount of their deposits and the period for which the bank holds them.
- Generally speaking depositors do not have the right to withdraw from these accounts as is customary in time deposits in conventional banks.

3.6 Some common Terms used in Islamic Banking

- **Al-wadia:**

Resale of goods with a discount on the original stated cost.

- **Hajj:**

Hajj means pilgrimage to Mecca and other holy places. Hajj, the fifth pillar of Islam, is a duty on every Muslim who is financially and physically able to carry it out, at least once in his lifetime. There is a specific period for Hajj, namely one week from the 8th day of the Islamic month of Dhul Hijjah to the 13th day of that month in the Islamic lunar calendar.

- **Shariah:**

Islamic cannon law derived from 3 sources: the Quran; the Hadith (sayings of the Prophet Muhammad); and the Sunnah (practice and traditions of the Prophet Muhammad).

- **Mudaraba:**

This is an agreement made between two parties: one which provides ‘100 percent of the capital’ for the project and another party known as a ‘Mudarib’ who using his entrepreneurial skills, manages the project. Profits arising from the project are distributed according to a predetermined ratio. Any losses accruing are borne by the provider of capital. The provider of capital has no control over the management of the project.

- **Murabaha:**

(Cost-plus financing) This is a contract sale between the bank and its client for the sale of goods at a price, which includes a profit margin agreed by both parties. As a financing technique, it involves the purchase of goods by the bank as requested by its client. The goods are sold to the client with a mark-up. Repayment, usually in installments is specified in the contract.

- **Riba:**

This term literally means an increase or addition. Technically it denotes any increase or advantage obtained by the lender as a condition of the loan. Any risk-free or "guaranteed" rate of return on a loan or investment is Riba. Riba, in all forms, is prohibited in Islam. In conventional terms, Riba and "interest" are used interchangeably.

- **Ijara:**

Leasing is also a lawful method of earning income, according to Islamic law. In this method, a real assets such a machine, a car, a ship, a house, can be leased by one person (lessor) to the other (lessee) for a specific period against a specific price. The benefit and cost of the each party are to be clearly spelled out in the contract so as any ambiguity (Gharar) may be avoided.