

Islamic Banking? Whats the deal?

Contributed by Aminur Rashid
Wednesday, 23 April 2008
Last Updated Wednesday, 23 April 2008

Offlate, a lot is being said about Islamic banking. Even Forbes magazine had one article on this form of banking.

This article from Reuters believes "Islamic finance can give early warning of debt woes".

With so much of talk going on, I tried to find out what actually is Islamic banking. The basis of this form of banking is the prohibition of Riba- (Usury - or interest). To digg further, it also does not allow your money to be invested in business declared as Haraam (illegal) in Islam. Some of them are liquor,porn industry, gambling (its always fun to gamble with other's money), pork food busines etc.

For the various sources, across internet I realised that this form of banking is basically a profit-loss-risk sharing form of institution. The end user also act as an investor in this form of banking, and as an investor, he is expected to keep an eye on bank policies. He is a partner in the business. It system employes the concept of participation, and, in its ideal realm, aims to work with social responsibility and social justice.

Concept and few terms can be explained as...

Islamic financial system can be explained as :

Now lets see some of the transaction under Islamic banking :

Mudaraba:

Trustee partnership based on mudaraba is a mode of financing through which the bank provides capital finance for a specific venture indicated by the customer. The bank, called rabb-al-mal is the owner of the capital and the customer-entrepreneur, called mudarib, is responsible for the management of the business and provides professional, managerial and technical expertise for initiating and operating the business enterprise or project. Profit is shared according to a pre-agreed ratio. Losses if any, are entirely absorbed by the capital provider – the bank.

Mudaraba may be of two types – restricted or unrestricted. In a restricted mudaraba (mudaraba al-muqayyada) the bank or the financier may specify a particular business in which investments may be undertaken. Mudaraba may also be an unrestricted one (mudaraba al-mutlaqa); in which case the mudarib may invest the capital provided in any business he deems fit.

Musharaka:

A joint venture based on musharaka involves a partnership in which both the bank and its customer-client contribute to entrepreneurship and capital. It is an agreement whereby the customer and the bank agree to combine financial resources to undertake any type of business venture, and agree to manage the same according to the terms of the agreement. Profits are shared between the bank and the customer in the pre-agreed ratio. Losses are shared strictly in proportion to their respective capital contributions.

These two are equity based financing product.

Let's continue with te Shariah compliant financing

Investment (Mudaraba) Deposits:

This is the core deposit product of an Islamic bank. The product is based on the concept of mudaraba and as such, is also known as profit-and-loss sharing (PLS) deposit or participatory deposit. It is perhaps the Islamic counterpart of the conventional fixed deposit product that disallows withdrawal prior to a maturity period. At times such deposits allow withdrawal, but only at the cost of foregoing the profit share. The product is based on the concept of mudaraba. Depending upon the degree of freedom accorded to the bank as the mudarib, intended end-use of funds or eligibility of depositors, there are several types of investment deposits.

General Investment Deposits:

This is a popular deposit product of Islamic banks under which an investment pool is established. The pool includes investment deposits of different maturities. The funds are not tied to any specific investment project but are utilized in different and continuous financing operations of the bank. Profits are calculated and distributed at the end of the accounting period, which is either three months, six months or one year.

Special Investment Deposit

This deposit account is similar in all respects to General Investment Deposit except that the depositor should meet the required minimum to invest in this product. For instance, the bank may selectively accept deposits from the government and / or the corporate customer. The modes of investment of the funds and the ratio of profit distribution may usually be individually negotiated. The product provides the bank with specific authorization to invest in a particular project or trade and the profits of this particular project only are distributed between the bank and its customers according to mutually agreed terms and conditions.

Reference from : <http://www.islamic-banking.com/>

Diagram and definitions from :

<http://islamic-finance.net/ifs/partone.pdf>

<http://islamic-finance.net/ifs/parttwo.pdf>