

## A GENERAL APPRAISAL OF ISLAMIC BANKING SYSTEM

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### Introduction

Islamic Banking is a relatively new phenomenon in the Nigerian Financial system. Of recent, the concept is gaining relevance in global finance. According to World Bank estimates, about hundred financial institutions in over forty-five Islamic and non-Islamic countries practice some form of Islamic finance. While Industry is said to have been growing at the rate of 15% annually for the past five years. Islamic Banking which is also referred to as interest free banking, is a financial concept devoid of interest (*riba*) which the Quranic Law forbids. i.e. " O you who believe, devour not usury, doubling and redoubling and keep your duty to Allah, that you may be successful and the payment of pre-determined guaranteed rate of return. This is at variance with the concept of interest and debt instruments that feature prominently in conventional banks. What is fundamental in interest free banking is that, the bank is not just a detached institutional provider of funds but also a real partner with a stake in the business. The bank, therefore, shares the risk as well as the proceeds that may come out of joint ventures. According to financial experts, the system encourages risk - sharing, provides entrepreneurships, discourages speculative behavior and emphasize the sanctity of contracts.

Initial reports on Islamic Banking suggested that it is open only to Muslim Customers. But the experience of countries, such as Pakistan, which practice this novel form of banking, does not seem to bear this out. From all indications, interest free banking is open to non-Muslim as well. ' Among the attractiveness of Islamic Banking system is the growing co-operation between it and the conventional banks

especially in such areas as long-term project financing. leasing. hire purchase. agriculture. short - tem trade finance etc. These have earned the Islamic Banking system an enviable position in global finance and economy. These banks. offer an opportunity for developing countries to have access to loanable funds at a zero rate of interest as against facilities offered by conventional banks that have deep-seated capitalistic undertone.

### **Evolution of Islamic Banking**

Historically. modern Islamic Banking started in Egypt in 1963 with the opening of a small bank known as Mil-Ghamr savings bank. It operated in the manner of a co-operative society. which promoted the offering of interest free loan for socially beneficial projects.

In later years. the discovery and sale of petroleum and allied resources in and around Arab Countries led to the arrangement of immense wealth by several Countries of the region. Thus, the religion financiers were confronted with the challenge of how best to Invest and redistribute these wealth which led to the establishment of

Islamic development Bank (IDB) in 1975 by forty-two (42) Muslim countries. Several other private Islamic Banks soon sprang up in many countries. In some of these countries., Islamic bank co-exist side by side with the conventional western styled bank, while in others, they are the only ones recognized officially by the government.

Conventional banking system, which is based on interest and biased in favors of the well-to-do, is alien to Islam and is rejected as un-Islamic because of the unequivocal Quranic prohibition of "*Riba*" which covers all kinds of interest. Usury or otherwise.

The prohibition of interest did not however, preclude the useful role played in a dynamic Islamic economy by the banking system. This resulted in the evolution of Islamic Banking during the last twenty-five years, of the idea of an interest free banking system. Consequently, the Muslim jurists were charged with the responsibility of providing an alternative banking system which is in conformity with the provision of the Shariah' and play all the roles of Conventional bank.

According to Dr. Muhammad. the quest stated in the late 19th century and between 3rd and 4th decades of the present century,° thus, some Muslim Ulama such as Rasheed Rida, Hassan al-Bannah, sayyid Qutb in Egypt. Abul Ala-Maududi. Abdul Hassan al-Nadwi (in India sub-continent) among others, wrote extensively on the need for Muslim scholars to take up the ideological challenge from the western world. These *Ulama* (Jurist) drew the attention of their disciples to the fact that western theories cannot be applied to solve problems in Muslim societies for the simple fact that the philosophical formulations of such theories run counter to Islamic philosophy. Western civilization they argued, is based on the separation of religion and state i.e. Handle the social, economic. political and technological question of human civilization without reference to God and His guidance. while this clarification by the *Ulama* (Jurists) was going on, development in the western world was vindicating them. These developments according to Dr. Muhammad were explained and outlined by professor Khrushid Ahmad who states that:

NOT only did the old problems remain unsolved, new ones emerged with threatening overdone, mass poverty, frustrated take-off in development, increasing disparities - at regional, national and international level. coexistence of hunger and affluence., incongruity between technology and development needs,

exploitation of the poor and the afflicted by the rich and powerful, inflation and stagflation all. Of these problems jailed to be tackled within the frame work developed by post Keynesian economics

All these problems led Muslim scholars, those based in Europe, America and even Nigerian to explore the possibility of constructing theories in social sciences particularly economics, based on Islamic value system rooted in the Quran and Sunnah Their effort culminated in the holding of the first international conference on Islamic Economics at Makka in February 1976 (1396 A.H.) under the auspices of the king Abdul Aziz University, Jeddah. A similar conference in Nigerian was organised in February 1985 (1405 A.H.) under the auspices of Uthman Dan Fodio University, Sokoto (then University of Sokoto) and subsequently many other conferences in various parts of the world were held, and writing of many books on Islamic Economics became widespread.

### **The Scope and Value of Islamic Banking**

Group or individual can establish an Islamic bank and operate financial services and arrangement in accordance with Quranic Law that prohibits *Riba* (usury/interest) since the concept of Islamic banking is premised on Islamic teachings as contained in the injunction of Allah in the Quran: "Trade is like usury. But God hath permitted trade and forbidden usury; God will deprive usury of all blessing. but will give increase for deeds of charity "The abolition of interest, however, does not mean that the saver will not get any return on his savings in an Islamic system. It only means that it would be variable (VRS-variable Return Scheme) rather than fixed (FRS-Fixed Return Scheme) in the present system.

Islamic banking is also about work ethics, wealth distribution, social and economic justice and creates a prominent role for the state in economic affairs. This is so because Islam prohibits interest that has nothing to do with influencing the volume of saving as it makes depression chronic, it aggravates the problem of unemployment, and finally. it encourages unequal distribution of wealth. The modern banks charge interest regardless of any loss or profit to businessmen. It would therefore, be seen that under a capitalist economy an organized attempt is being made to further the interest of the rich, thereby eliminating the possibility of establishing economic equilibrium in society. As against this. Islam has tried to bring about economic equality in the state by imposing zakat on surplus funds. In short, banks are regarded by Islam as one of the boldest means for the economic prosperity of a nation.

The scope of Islamic bank is so wide and its role is to mobilize savings on a large scale., pooling money from savers with different sums to Invest, for different periods at different risk levels through its various products conforming to shariah.

Some of the Islamic Banking products whose conformity with Islamic Shariah has been established are discussed extensively under the attractiveness of Islamic Banking system.

### **Attractiveness of Islamic Banking System**

The beauty of Islamic Banking system could be better understood after analyzing the variety of services it renders to its customers. These services are describe as "Islamic banking products by Lawal Husain

### **Financial Services Rendered by Islamic Bank**

Below are some of the services rendered by Islamic banks at a glance:

(i) *Mudaraba* Account (ii) Loan (current) Account (iii) Social services Account:

(a) Short-term financial arrangement (*Murabaha*)

(b) Lease arrangement (*Ijara*)

(c) Agricultural financial arrangement (*Muzara* and *Musaqat*)

(d) Payment of zakat.

(iv) Guarantees. Transfers and collections

(v) Bills Discounting (vi) stock markets

(vii) Foreign Remittances (viii) Transfer of Debts and Bill for collection

(ix) Assets Management.

#### **i. Mudaraba Account**

*Mudarabah* is defined as a contract in which one party; the owner (*rabbulmal*) provides capital while the other party (*Darib*) brings labour and effort with the provision of profit sharing in some predetermined proportions. still on the definition, kilani (1994) quoted sarakhsi to have said that:

*Mudarabah* is derived from "*Darib* on earth". It has been so named because the *Mudarib*, user of others capital qualifies to get a share of the profit on account of his endeavours and work.

He thus participates in the profit as well as having the right to use capital and strive according to his discretion.

Islamic banking will be based on the universally recognized principles of *Sharikah* (partnership). That is, the whole system of banking in which the shareholders, the depositors, the investors and the borrowers will participate on a partnership basis. This will work through the application of the eternal principle of *Mudarabah*, where labour and capital can be combined together as partners for work. This is not merely a partnership in the modern sense of the term. It is something more than this. because Islam has provided a code of economic ethics combining the material and spiritual values for the conduct of its economic system. This code of economic ethics. has to be reflected when the principle of *Mudaraba* is put into practice. The Islamic banking system can help established certain institutions on the basis of *Mudarabah* and thereby solve the age-long conflict between labour and capital. Industrial. commercial and agricultural enterprises can be worked out on the principle of *Mudarabah* combining the various units of production. The income resulting from such enterprises can be shared proportionately among the various units of production after deducting all the legitimate expenses of the entrepreneurs during the year.

It is indeed gratifying to note that Islamic banks are actually involved in dealing with *Mudarabah* contracts, under which banks provide the capital and the clients their expertise and the profit are shared according to an agreed ratio. It has been suggested that the *Mudarabah* principle can be invoked in the case of self liquidating short-term operations, and as a result the demand for short - term loans can be reduced substantially, because in an Islamic economy short-term loans on

interest from the traditional commercial banks or discount houses will not be available.

## **ii. Loan (Current) Account**

Individual or Organizations can keep current account for their day to day transactions as is obtained in other conventional Banks. The difference is that the deposits will not be used to give loan with interests, and the bank will not credit anything to account holders. This type of account is called loan account in Islamic Banking because the depositors themselves are considered as creditors to bank and secondly.

the bank can only give out the fund as loans to the account holders.

## **(iii) Social Services Account**

The aim is to widen the ways of assisting the needy through advancing interest free loan and executing some projects as social services to the society (free of charge). The banks source the fund for this account by co-operating with other people in the society and making use of *Zakkah* money from the eligible payers. among their clients in accordance with Islamic law. Such services include the following:

### **(a) Murabaha**

This is a form of transaction that covers short term commercial financial agreement. Under a Murabaha contract, the lender takes actual title and sells the goods to borrower on an agreed date at a profit. For example, a bank may agree to



finance importation of essential drugs for a pharmaceutical company under its own name and sells them to this company. By delaying taking payment until the drugs have been sold, the bank and its investors gain a return on their funds. This return is based on the risk that the bank undertook when it first purchased the drugs, and the possibility of subsequent loss or devaluation of the assets, as well as the increase on value of the product. The lender's fee is calculated according to a formula that take into consideration the cost of other financing available to the business.

### **(b) Ijara**

IJARA transaction covers leasing and hire purchase arrangement To goods as vehicles; aircraft or computer equipment essentially the same as obtained in the conventional bank. The only difference is that, the leased asset must be put to productive use rather than simply using the lease to produce a paper profit.

### **(c) Muzara'ah**

This is a type of transaction designed for agricultural financing. The bank enters into partnership with the farmer or an agricultural enterprise. While the bank: purchases and supplies the necessary equipment and seeds, the farmer or agricultural enterprises contributes land and labour to the venture. Whenever the transactions relate specifically to the land as in the financing of irrigation projects. it is called *MUSAQAT*.

### **(d) Payment of Zakat**

This is done by Islamic banks with the co-operation of the Zakat committee. Zakat (taxes of alms) is deducted from the eligible bank customer whose deposits satisfies the required criteria dictated by Islamic Law.

**(iv) Guarantees, Transfers and Collection**

These Operations include performance bonds. letters of guarantees. letter of credit. traveller's cheques. money order and transfers. foreign exchange transactions and safe deposits etc. These services are provided to clients on commission and service charges to cover for agent and management services respectively with exception of letter of guarantee, the banks are allowed to charge the exact expenses for the services and commission when the transaction is done on behalf of the clients e.g. sale of goods or precious stones.

**(v) Bills Discounting**

This is an act of endorsing a bill of exchange by the beneficiary to a bank in consideration thereof. The bank pays the beneficiary the value of the bill in advance less the amount (value) discounted. Islamic bank objects to charging of commission, endorsement fees plus interest in this case.

**(vi) Stock Markets**

Islamic Banks are seen as traders engaged in trading and selling guided by the conditions below:

- (a) The company issuing the shares should not deal or trade on banned operations and should not be a financial institution whose main activities are directly related to trading in interest based securities or syndication underwriting, and management of interest based bonds.

- (b) Dividend or yield should not be guaranteed or stated in advance
- (c) Dealing in preference shares are not allowed on the grounds that they entitle the holder to preferences right as to dividend and they bear a fixed rate of return.

Other transactions forbidden in this market include banker's acceptance, inter bank loans. (except benevolent loans and participation- *Musharakah*) short sales, trading on the and issuing of certificate of deposits and bonds due to fixed rate of return and accompanying risks in the instrument. However. where the rate of return is tied to the profit of the project or investment. it can be valid.

#### **(vii) Foreign Remittances**

Transfers and remittances can be effected locally and or across international boundaries by measure of cheques. drafts. money order etc. on behalf of the client by banks through: telephone. telex. radio. fax etc. as bid to curtail risk associated with the movement of liquid cash. They can charge commission or service charge

#### **(viii) Transfer of debts and bills for collection**

This is made to client for a fee or service charge. The client can instruct the bank to collect or transfer some debts on his behalf.

#### **(ix) Assets Management**

Islamic Banks like Merchant banks. raise capital from shareholders and may take equity stake in their clients business. However. Islamic Banks apply a more liberal and human approach to asset management. This approach obliges the banks to assess the long-term profitability. rather than simply the credit worthiness of the firms (i.e. provision of collateral) to which they lend.

The Islamic Banking system owes depositors a direct stake in Industrial profitability or loss and its economic growth. rather than channeling risk. through financial intermediaries with the reward of interest *riba*.

### **Sources of income**

Islamic Banks source their funds or income through:-

(a) Exchange Transaction i.e. *Murabaha*. *Ijara*. *Muzaru ah* and *Musuqat*. (All have been discussed above)

(b) Partnership or Equity Transactions i.e. *Murabaha* and *Musharakah* Transactions  
*Musharakah*

*Musharakah* transaction offer equity participation to investors embarking on partnership ventures in project financing on long term basis. generally with high initial investment and limited short-term return. Here. shares of profits and losses are agreed to when the partnership is formed. (All other transactions have been explained earlier)

### **Conclusion**

Islamic Banking as pointed out in this paper is an interest free financing system essentially based on profit and loss sharing. All its operations are in conformity with Shariah. It is therefore the cornerstone of the Islamic economic system which is by definition interest-free. Constant circulation of resources for social welfare and productive purposes within bounds of prohibition of interest of any kind and permission of trade production and consumption of Halal (Lawful) items are the divine and guiding principles of economic system of Islam. Under the circumstance

therefore, Islamic Banking with a variety of products is a great innovation of the Muslim scholars of modern time.

In the final analysis, I would therefore like to share the views of Lawal Husain in stressing that there is need to have a permanent forum for cooperation and dissemination of Islamic banking knowledge in the world. That institution like the Islamic Development bank could be of assistance to Islamic banking. Not only that, Islamic bankers, should focus attention on two major areas; first, on the need to introduce Islamic banking as a separate stream of knowledge, and secondly, on developing a mechanism whereby the surplus funds from Muslim countries could be moved to deficit Muslim countries through channels of Islamic banks. Thus, it could be suggested that the subject of Islamic banking should form part of University curriculum of Muslim Countries and the greater cooperation and Integration among Islamic banks should be increased to a point where the possibility of optimal utilization of Islamic funds could be ensured.