

# Banker's Academy

# BRIEFINGS

## ***Banking on Sharia Principles: Islamic Banking and the Financial Industry***

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There are an estimated 1.61 billion Muslims worldwide, making Islamic banking one of the fastest growing segments of the financial industry. Banks serving the Islamic population must comply with several very specific principles of Islamic law if they hope to retain existing customers and attract new ones. Banks must be ready with specialized products and services and they must put programs in place to train their personnel to support these products and services in order to exist in this competitive marketplace.

The basic principle of Islamic banking follows the laws of *Sharia*, known as *Fiqh al-Muamalat* (Islamic rules on transaction). The term “Islamic banking” is synonymous with “full-reserve banking” and “*Sharia*-compliant banking.” The most prominent feature of these laws is usury – the prohibition of paying or collecting interest on funds. The Islamic terminology for this is *riba* or *riba*. The *Sharia* also forbids engagement in investments that include financial unknowns such as buying and selling futures, as well as businesses that are *haram* – dealing in products that are contrary to Islamic law and values such as alcohol, pork, gossip or pornography. These principles apply to all individuals, companies and governments.

Banks that comply with Islamic law are forbidden to charge interest or late payment fees, which is also considered a type of *riba*. To minimize risk, banks will often require a large down payment on goods and property, or insist upon large collateral. It is lawful for the Bank to charge a higher price for a good if payments are deferred or collected at a later date since it is considered a trade for goods rather than collecting interest. *Sharia*-complaint banking products include *Mudharabah* (profit sharing), *Wadiyah* (safekeeping), *Musharakah* (joint venture), *Murabahah* (cost plus) and *Ijarah* (leasing). Another way that banks work within Islamic laws while trying to turn a profit is by buying an item that the customer wants, and then selling the item to the customer at a higher price.

The *Mudharabah* is a partnership between an entrepreneur and the bank. The bank is known as the *rabal-maal* and the entrepreneur as the *mudarib*. The bank provides all of the necessary capital to start a business and the entrepreneur does the work of managing the business. Profits are split at an agreed ratio until the initial funds of the *rabal-maal* are paid off. The *rabal-maal* is also compensated with additional funds based on the profits of the business in terms previously agreed on. In the event that the business folds, the *rabal-maal* shoulders the cost and the *mudarib* is not compensated.

*Musharakah* is similar to *Mudharabah*, in which an entrepreneur seeks funds for a business venture and pays the bank back with a ratio of profits. However, there are often more than two parties who contribute funds and become partners who can influence the business depending on the amount of money invested. The entrepreneur also contributes funds and shares in the risk. Any loss is proportional to the amount of capital invested in the business.

In *Wadiah*, a person transfers custody of their funds to the bank and the bank maintains custody of those funds (usually in a savings or current account) until the customer pays his/her debt in full. The bank will often charge the depositor for the services rendered in keeping the valuable asset, and will also invest the asset accordingly to generate profitability for the bank. During this time, the bank is regarded as a keeper and trustee of the funds and becomes responsible and liable for its safekeeping, with a guarantee refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands repayment. At the bank's discretion, the depositor may be rewarded with *Hibah* as a form of appreciation for the use of funds by the bank.

*Hibah* is generally awarded to customers of Islamic banks, who may voluntarily pay their customers a "gift" on savings account balances which represents a portion of the profit made by using those savings account balances in other activities, such as investing in specific projects such as real estate or in accordance with the individual's needs.

*Zakat* is a personal religious tax due yearly on certain types of property and often relates to *Wadiah*. *Zakat* is distributed to eight categories of individuals specified by the Qur'an. These categories are usually defined to include orphans, the poor, travelers, beggars, debtors, slaves, and the efforts to propagate Islam. *Zakat* is payable at different rates on crops, harvests, herds, gold and silver, and merchandise. Liquid assets, which fall under the category of gold and silver, are taxed at a rate of 2.5% of an individual's capital.

*Murabaha* governs the issuing of home loans or any other type of goods needed by a borrower. An Islamic bank does not lend money to a borrower to buy properties; rather, the bank will purchase the property at the borrower's request at a freely disclosed price, and mark up the price for the borrower to pay back, therefore making a profit from the investment. The borrower is named on the title and allowed to utilize the property immediately and pays the bank back in installments.

Another type of loan is the *Ijara*, in which the bank buys the home or item and leases the property to the borrower while retaining ownership of the property. The borrower can either use the property for a pre-determined period of time, or pay off the purchase price and buy out the Bank to attain full ownership of the property.

There are occasionally controversies surrounding the interpretation of the *riba*, which certain scholars argue was meant to prevent petty money-lenders from abusing borrowers, rather than a modern bank charging a reasonable, agreed upon interest. The general consensus, however, is that any interest is a direct violation of the law of Sharia and therefore unethical.

While each Islamic bank has its own board which rules on ethical banking principals, Islamic banking organizations have been establishing standard regulations and policies. The Islamic Development Bank has been working on international standards, policies and procedures, and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Finance Service Board (IFSB), International Islamic Financial Market, Liquidity Management Center and International Islamic Rating Agency are in development to ensure accurate and fair banking practices.

Today, Islamic financial institutions exist worldwide, participating in the \$180 billion/day industry. In 1975 there was one Islamic bank; today there are over 300 in more than 75 countries. Islamic banks have become more prevalent worldwide and can be found in high numbers in such countries as Indonesia, Pakistan, Bangladesh, Nigeria, Egypt, Turkey, Iran, Sudan, Algeria, Morocco, Iraq, Uzbekistan, Afghanistan, Malaysia, Saudi Arabia, Yemen, Syria and Kazakhstan. The total amount of deposits in Islamic institutions, balance sheets, assets under management and private wealth are growing at a rate of 25-40% annually. Because oil prices and liquidity are expected to stay at the same levels throughout 2007, budget surpluses will remain high, pushing both public and private sectors to be involved with the Islamic market. Many Islamic countries are investing in large infrastructure projects, creating more than a trillion dollars in investments. There is also a huge potential customer base. According to Standard and Poor's surveys, 20% of the customers in the Gulf Area and Southeast Asia would choose an Islamic banking product over a similar conventional product. There are significant middle-class urban and suburban populations that already use conventional banking, and therefore present ripe opportunities for Islamic banks. Most important to note, outside of the religious and political allure of Islamic banks, is that people are choosing their services for the safeties they offer. The evidence is clear: Islamic banking is big business and it is growing every day.

However, in order for Islamic banks to be competitive with conventional products and attractive to customers, Islamic financial products must meet the risk/reward profiles of investors and issuers while fulfilling the tenets of the Sharia and remaining sufficiently cost-effective. Additionally, Islamic banks must educate their personnel to understand the tenets of Islamic law that pertain to banking, and to train them to comply with Sharia as they serve their Islamic customer population.



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