UDC 336.71:28
Professional paper

Gule GULEV*)

ISLAMIC BANKING - BASIC PRINCIPLES AND CHALLENGES

Abstract

The current situation in the European economy release on a surface a signal about the need of new types of operating of the financial institutions, especially banks on sound and stable manner. This was a trigger for the focus in this article and attempt to closely review Islamic banks as the part of Islamic finance institutions.

For this purpose, it is briefly analyzed, the role of Islamic Law and the basic principles of Islam in comprehensive functioning on Islamic banks and their influence in financial and commercial transactions according to the Shari'ah. This was a good way to understand specifics of Islamic banking and review of several challenges they are facing within the conventional banks environment in non-Muslim countries.

Many efforts have been put, but many things remain to be researched and completed by both sides, the regulatory agencies and the Islamic banks, to exceed the open questions.

Key words: Islamic finance, Islamic bank, Conventional banking, Shari'ah, basic principles.

JEL classification: G21

Introduction

The Islamic banking describes the sector of banking, which follows the rules of Shari'ah, the Islamic law. The Islamic banks, in particular, are geared primarily towards local consumers and small businesses and includes, among other products,

*) M.sc.- Institute of Economics –Skopje, E-mail: gulev@ek-inst.ukim.edu.mk

interest-free current accounts, Shari'ah-compliant savings products, Islamic mortgages and other interest-free financial services. Regarding the above mentioned, the Islamic banking always arise the attention, especially within the countries with conventional banking systems which are currently in financial crises. The raised interest is guided from the data which represent continuous arising of the Islamic economies and in the Islamic banking as a whole. Since the beginning, almost three decades ago[1)], the world financial circles had doubts about its sustainability, particularly because of the highlighting of the relation between the ethics and the finances. Nowadays, the Islamic banking succeeded to show that it has potential for greater global influence and it became a growing force in global financial circles.

The Islamic Banks found in over 70 countries worldwide and in the 10 years preceding 2005, the growth rate of Islamic Banking assets had been ~15% p.a. In 1999 Dow Jones created 'Islamic Indexes' to offer Sharý'ah-compliant investment portfolios to cash-flush pious Muslims. Several major Western banks, e.g. Citibank, ABN Amro, Bank of America, HSBC, Standard Chartered and the Union Bank of Switzerland, either have Islamic Banking subsidiaries or offer Islamic financial products to their customers. Clearly Islamic Banking and Finance has transformed itself from an obscure financial experiment to a major factor in global finance.[2)] According to the data of the Federal Reserve Bank of San Francisco, the total assets in the Islamic finance market totaled between USD750bn and USD800bn as of July 2009. The figure may exceed USD1 trillion in 2010. Iranian Islamic banks still dominate the market with a share of 40% of the top 100 bank's total assets. Together with Saudi Arabia and Malaysia, the three countries make up the key players in Islamic finance.[3)]

It is important to highlight that Islamic banks generally operate within three different types of environment. The first one includes countries which have completely adopted the Islamic Shari'ah principles (e.g. Iran, Pakistan). The second one includes predominantly Muslim countries where along conventional banks, function

---

1) The first tentative steps toward the creation of nointerest "Islamic" banks were taken in the 1960s. The initiative gained further momentum a decade later, in the aftermath of the spectacular increase in oil prices and state revenues during the early 1970s. Governments and private foundations in Saudi Arabia and the Gulf committed some of their new wealth to religious programs, including think-tanks and institutions dedicated to the cause of Islamic banking. The founding of the Saudi-finance Islamic Development Bank in 1975 lent additional support to the cause, since the bank was supposed to sponsor interest-free financial institutions., Hefner R. W., *Islamic Economics and Global Capitalism*, SOCIETY, (Volume 44, Number 1), November/December, The State University of New Jersey, USA, 2006, p.18.

2) Khan F., *How 'Islamic' is Islamic Banking*?, Journal of Economic Behavior & Organization 76 (2010), doi:10.1016/j.jebo.2010.09.015, 2010 Elsevier, p.805.

3) Federal Reserve Bank of San Francisco, *Islamic Finance: Malaysia's Growing Role*, Asia Focus, Country Analysis Unit, July 2009. www.frbsf.org/publications/banking/asiafocus/2009/asia_focus_july_09.pdf

also the Islamic banks (Arab countries). The third one, which is the most specific one, includes non-Muslim countries with dominant conventional banking system, where the Islamic banks attempt to enter into the financial market with Islamic financial instruments.

To understand the Islamic banking, first of all, it is necessary to make brief review on its basic principles. These are the principles upon which the Islamic financial and the whole legal system is based on. This is the way to clarify some challenges and obstacles which arise while introducing the Islamic banking in western, conventional financial systems along conventional banks.

1. ECONOMIC ENVIRONMENT AND LEGAL FRAMEWORK

Within the Islamic Economy, the Islam is not only a religion but also a codification of the general standards of behavior that reach far beyond the contents of belief. It declares close connectivity between the economy, politics, social aspects and religion. In particular, in financial matters, the trade and commerce are encouraged by the Qur'an as long as they are honest and legitimate. Islamic financing is based upon several root transactions which lead to the most important concepts of partnership or profit and loss sharing. These basic elements create a solid basis for the understanding of the products and compliance structures in Islamic banking institutions. The four root transactions according to Shari'ah are the following: sales (Bay), hire (Ijâra), gift (Hiba) and loan (Ariyah), describing respectively the transfer of ownership, the transfer of the right to use, the gratuitous transfer of ownership and the gratuitous transfer of the right to use. These basic forms are applied to specific transactions such as pledge, deposit and guarantee and create the basis of all transaction structures within the Islamic finance. Although, the Muslims that live in countries where the Islamic banking or the Islamic banking windows in conventional banks, does not exist, they are allowed to use conventional banking products.

The Islamic legal system is based on the Islamic law which promotes a certain code of behaviour according to the Qur'an. Shari'ah is much wider in scope than the concept of law as understood in the West. Shari'ah law encompasses aspects of belief and religious practice, including rules relating to prayer, fasting, the making of the Haj and giving Zakat. It also covers aspects of everyday life such as behaviour towards other people, dietary rules, dress, manners and morals. Lastly, it includes laws relating to crime and evidence, international relations, marriage, divorce and inheritance, commercial transactions and many other subjects that would be included under the Western definition of law.[4)]

---

4) Venardos Angelo M., *Islamic banking and finance in South-east Asia : Its development and future,* World Scientific Publishing Co. Pte. Ltd., Singapore,2005,p.27.

In practice there is no universality of Islamic law, as it is applied adhering to the principles of analogical reasoning and independent human reasoning of those specialized in law. The Shari'ah scholars are experts in Islamic law, who can interpret the Shari'ah themselves and this results in a great flexibility in law making.

2. BASIC PRINCIPLES OF ISLAMIC BANKING

As it was previously mentioned, Shari'ah has great influence on the Islamic economy and its legal systems, and therefore the Islamic banks are obligated to follow the basic principles of Islamic financing, such as: the prohibition of interest – Riba; the prohibition of gambling and transactions involving speculation - Maysir and Gharar; the code of ethical investment - Halal and Haram; and the social duty to benefit society – Zakat.

2.1. Prohibition of interest

In an Islamic literature, interest and *riba* are treated synonymously, and the prohibition of interest is the main characteristic that distinguishes the Islamic economy and the Western countries economy. The prohibition of interest is not an exclusivity of the Islam, it is also prohibited in all monotheist religions (See Exodus 22:25, Leviticus 25:35-36, Deuteronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12).[5)]

According to the historical data, the prohibition of *riba* has not ever been in force within the Islamic economy. In Islamic societies, financiers (and not just village moneylenders) operated on an explicitly interest-based basis and financial transactions were never characterized by the predominance of direct-equity participation. After analyzing 17th century Ottoman Sharý'ah court records from the town of Kayseri, concludes that interest rates below 20% "were accepted by the entire religious community as in accordance with the Shari'ah" and offering collateral or third-party guarantees for loans was also common practice. Similarly, in their study of 18th century Egypt find that trade between it and the Barbary States was normally financed at rates varying from 7% to12% per annum and "that to take interest over 10% was regarded as usurious.[6)]

In the Muslim world there is a substantial difference between profits resulting from entrepreneurial activities and profits generated by granting loans. In order to

---

5) Shaikh S. .A, "*A Brief Review & Introduction to Practiced Islamic Banking & Finance*", January 14, 2010, p.2. http://ssrn.com/abstract=1536943

6) Khan F., *How 'Islamic' is Islamic Banking*?, Journal of Economic Behavior & Organization 76 (2010), doi:10.1016/j.jebo.2010.09.015, 2010 Elsevier, p.810.

understand the principles of financing in Islam, the distinction between *riba* (interest) and bai' (sale) is of crucial' importance looked into the difference between *bai'* and interest in the context of the equitable distribution and efficient management of risk. In interest-based transactions, risk is transferred to the borrower so that all interest-bearing assets become risk free. This is socially inequitable and economically inefficient. On the other hand, trade by conforming to natural uncertainty is not only equitable but also efficient. This is generally used as a criterion to differentiate riba-based transactions from sale/trade.[7)]

In terms of *riba* prohibition, in case of insufficient resources, there are two ways to finance any commercial venture in Islamic economy: to enter into a partnership or to borrow interest-free money. The first one is profit and loss sharing (PLS), and it simply means that, instead of lending his money and becoming a creditor, the provider of financial capital joins the borrowing entrepreneur in the enterprise and, in return for the funds supplied, he shares the profits as well as the risks of the business; hence becoming a partner of the enterprise.

The second one is non-profit and loss sharing (non-PLS), where the financier may choose to be non-participatory and not to take an equity stake which is more closely to trade-based financing modes, than to partnership.

2.2. The prohibition of gambling and transactions involving speculation - Maysir and Gharar

Islamic banking and finance rest on certain principles and ethos that govern not only the interest-free mechanism but also several other prohibitions and unethical practices discouraged by the Shari'ah. These include such practices as uncertainty (gharar), cheating (ghish) and gambling (qimar).[8)]

In any case of having enrichment through games of pure chance, without effort it is forbidden according to the Qur'an. Maysir is involved in contracts where the ownership of a good depends on the occurrence of a predetermined, uncertain event in the future. In other words, there will be a gain for one party and a loss for the other party, but when the contract is signed, it is not sure who will be the winner or the loser. The transactions which contain excessive risk are supposed to foster uncertainty and fraudulent behavior. Consequently every contract that is created on speculative assumptions should be avoided. However minor uncertainties and a certain degree of risk are permitted as it is involved in every economic activity. In an economic context

---

7) Kahf M., Khan T., *Principles of Islamic Financing – A Survey*, Research Paper No. 16, Islamic Research and Training Institute, Islamic Development Bank, 1413H (1992), p.19-20.

8) Ahmad K., Rustam, G.A. Dent M.M., *Brand preference in Islamic banking*, Journal of Islamic Marketing Vol. 2 No. 1, Emerald Group Publishing Limited, 2011, p.75.

the ban of Maysir and Gharar has particular relevance for financial markets notably the derivatives market and the insurance business. As a derivative financial instrument speculates, in general, on the development of its underlying value (for example in future contracts or short-selling transactions) the concept of Gharar applies.

Therefore the trade of all conventional derivate instruments is impossible in Islamic finance, and also for the Islamic banks within the conventional systems.

2.3. Code of ethical investment - Halal and Haram

In Islamic economy exist several ethical and social criteria for exclusion regarding the investment targets and financial products. The forbidden and not admissible actions and businesses are called Haram whereas legal and permitted activities are referred to as Halal. Neither private investors nor companies or banks are allowed to invest in Haram businesses dealing with, for instance, alcohol, tobacco, pork-related products, gambling, cinema, pornography and such like.

As it was already described before, in the Islamic financial service industry, *riba* is forbidden. Thus, the securities issued by banks that operate in the conventional, interest-based financial system are not admissible for Muslim investors. Furthermore, it is forbidden to invest in companies that are debt-ridden. These Shariah requirements are of special importance in stock investment and Islamic mutual funds. In order to separate Halal investments from Haram stocks, a sophisticated screen process has to be executed.

2.4. The social duty to benefit society – Zakat

In Islam, wealth is regarded as a trust from God and should therefore take over a social duty in order to benefit society. It is an obligation for the Islamic state to guarantee a fair standard of living to its people and to balance social imbalances. The most important mechanism is establishing a Zakat-fund within the Islamic financial institutions, and than to redistribute the collected fund to the deserving poor, either directly or via religious institutions. The concerned assets include initial capital, reserves and profits. The calculation and payment of the Zakat is overseen by the Shariah Supervisory Board.

3. SOME CHALLENGES ON INTRODUCTION ISLAMIC BANKING IN CONVENTIONAL BANKING SYSTEMS

The current changes in the world economy, the revolution in information technology and globalization is resulting in dramatic changes in the world trade, place pressure on businesses in general and banks in particular. The most interesting for us,

are those that function in predominantly non-Muslim countries along with conventional banks.

What is interesting about the European case is that countries such as the United Kingdom (UK), France, the Netherlands, Spain and Germany progressed at very different speeds towards developing Shari'ah compliant financial retail products and services. In fact, the UK has emerged as the spearhead of Islamic Retail Bank in Europe and the entire Western World whereas, for example, the German Islamic Retail Bank market must still be regarded as being in its infancy. Expansion of IRB in Europe is not only a matter of technical implementation, but also an economic, legal, political and ultimately a fundamental societal issue.[9)]

Some of the challenges that should be reached in direction of fully integration of the Islamic banking institutions in European and other conventional banking system, are the following:

Lack of Standardization – It appears because the interpretations of Islamic Shari'ah principles are left to Muslim scholars, that are from different schools, cultures and Islamic societies. Due to this, there is a disagreement on some basic issues[10)], and therefore each Islamic bank appoints a Shariah Supervisory Board whose remit is to assess whether its bank transactions and activities are in accordance to the Islamic Shariah.[11)] The lack of standardization is time-consuming and costly for the Islamic banks, and it is an obstacle to its widespread acceptance, especially in understanding the idea of Islamic banking by the regulatory agencies. Thus, standardization is expected to clarify the functions of Islamic banking and to better the understanding and the acceptance of Islamic banking as a serious competitor to the conventional banking system.

Regulation and Legislation weaknesses of the Islamic banking are the result of its not sufficient developed regulatory and supervisory techniques, which differs it from the conventional banking system, which has an effective regulatory and supervisory bodies. One of the major problems facing the development of Islamic banks is the current legal structure. In particular, such provisions should determine which

---

9) Volk S., Pudelko M. , *Challenges and opportunities for Islamic retail banking in the European context: Lessons to be learnt from a British – German comparison*, Journal of Financial Services Marketing Vol. 15, 3,, Macmillan Publishers Ltd. 2010, p. 192.

10) For example, the prohibition of *riba* (interest) *vis-'a-vis* the prohibition of *'inah* sales (double sale by which the borrower and the lender sell and then resell an object between them, once for cash and once for a higher price on credit, the net result being a loan with interest). Venardos, Angelo M. *Islamic banking and finance in South-east Asia: Its development and future*, World Scientific Publishing Co. Pte. Ltd., Singapore,2005,p.99.

11) Nienhaus V., *Governance of Islamic banks*, Handbook of Islamic banking, Edward Elgar Publishing Limited, U.K. 2007, p136-140.

enterprises may call themselves Islamic banks, collect deposits and carry out banking practices on the basis of Islamic principles. Moreover, it should be clearly established that the central bank (or a separate supervisory authority) has the authority and all necessary powers to supervise Islamic banks as well as conventional banks, if applicable.[12)] This causes tension between Islamic banks and regulatory agencies, which need to hold very strict policies about banking and to stand firm their definition of a bank as an institution that can guarantee deposits and provide a declared return on them.

Capital and Liquidity Requirements is another issue related to regulation and supervision of Islamic banks, which arises from the Basle Committee's minimum capital requirement.

The Basle Committee overestimates the risk to Islamic banks' assets and finds them more risky than the conventional banks. This is because conventional banks maintain a large portion of their assets in fixed interest–bearing deposits that are relatively easy to value. In return, the value of an Islamic bank's assets, invested in long-term projects and ventures, is difficult to assess. Moreover, the Islamic bank cannot use the central bank as a safety net and take advantage of its services as a lender of last resort because of the interest that must be paid on the loan during repayment.

Financial Instruments of the Islamic banks are related to the profit and loss sharing (PLS) techniques. One of the weaknesses of the PLS technique is that it is long-term and has a higher degree of uncertainty, which requires the banks to be continuously involved in rigorous analyses, evaluations, and assessment procedures in order to determine the risk and returns. Another problem related to the financial instruments of Islamic banks is the lack of short-term instruments to meet short-term capital needs and immediate liquidity concerns. Providing this service under an interest-free regime, possesses certain problems, which can be attributed to the application of PLS on short-term loans, which effectively means that risks and returns must be calculated for short periods of time. The classification of a short-term loan is typically from one day to a year. This cannot be considered as an acceptable solution, since the Islamic bank is set out to be a business rather than a charity.

Accounting Practices and policies adopted by Islamic banks present another technical problem. Islamic banks are based on different set of objectives, beliefs, and assumptions from conventional banking institutions.There are three main areas of difference between Financial Accounting Standards (FAS) developed for Islamic banks and conventional accounting frameworks. They relate to the treatment of investment accounts, the concept of substance over form and the time value of money.[13)] These

---

12) Venardos Angelo M., *Islamic banking and finance in South-east Asia : Its development and future*, World Scientific Publishing Co. Pte. Ltd., Singapore,2005,p.111.

13) Venardos Angelo M., *Islamic banking and finance in South-east Asia : Its development and future*, World Scientific Publishing Co. Pte. Ltd., Singapore,2005,p.102.

assumptions lead to different types of transactions such as Zakat funds, PLS sharing accounts, and so forth, all of which must be accounted for in the books. Empirical evidence on Islamic banks' financial reporting practices is plausible that IASs are unable to sufficiently reflect all transactions of Islamic banking in an acceptable manner.

Risk management is one of the most important activities of any bank and both conventional and Islamic banks are subject to similar risks. Islamic banks are more vulnerable to investment risk, due to the longer-term nature of their transactions. In another hand, the interest-rate risk plays an important part in a conventional bank but is non-existent for Islamic banks. As it was explained for the other questions before, risk management is more developed area in the conventional banking system than in the Islamic banking system, which is a challenging task.

In terms of well established conventional banking system, there are limited possibilities for training the employees in Islamic banks.[14)] The lack of professional courses and trainings resulted in lack of qualified staff. This may cause slow innovation of the Islamic banks products and instruments and affect relations with central banks due to the inability to clarify and explain various issues to them.

4. CONCLUSION

The current situation within the economy, in particular, in EU countries, the new movement in financial integration processes between Russia and other former soviet states and the investments in Europe and USA from Arabian world, might result in serious changes in global busines relationships, and the position of the Islamic banks in particular. Although, the conventional banks will remain as key players on markets, the further developments and innovations which occur in the Islamic finances, will increase Islamic bank's potential and secure them better market position.

In the long run, the sustainability of Islamic banking rests on two pillars. The first one is satisfying the demand for quality of products and services that Islamic finance can offer. This means having ability to provide a comprehensive range of Islamic financial products and services which are not only Shari'ah compliant, but also enough innovative and competitive with conventional financial instruments. The second one is related to the comprehensive regulatory framework for Islamic banks in conventional banking environment which includes an effective prudential supervision on Islamic banks.

---

14) Abdul-Rahman Y., *The art of Islamic finance and banking:tools and techniques for community-based banking*, Published by John Wiley&Sons, Inc., Hoboken, New Jersey, USA, 2010, P.331.a

Despite this, Islamic banking institutions must be a subject on clarifying several points with introduction of:

- an appropriate risk management, taking into account the modes of the Profit and Loss Sharing,
- an instrument and mechanisms in Islamic financing systems according to Shari'ah which will guarantee sound and stable condition to the Islamic banking institution,
- high level of standardization and create confidence in its depositors as well as all the other operators in the market through foundation of Centralized Shari'ah Board, introducing Shari'ah clearance, internal audit and external audit,
- a training of both, the staff and the clients of the banks, and inform the general public about the principles of Islamic banking,
- a development an Islamic financial market, in particular, the secondary market for Islamic financial instruments as better manner for Islamic banks to manage their liquidity,
- a facility which will function as the lender-of-last resort, which is available to conventional banks in the face of the Central Banks, to overcome the liquidity crises when they suddenly occur.

Resolving these points is not a simple task under the Shari'ah requirements. But, reaching these challenges brings the Islamic banks on a better position, especially in EU countries, where the Central banks will allow them to continue their operating under banking acts.

The place and significance of these principles and readiness to accept the primary rules of operation in Europe countries at first side, will determine the future presence of Islamic banking in western banking systems.

References:

- Abdul-Rahman Y., *"The art of Islamic finance and banking:tools and techniques for community-based banking"*, Published by John Wiley&Sons, Inc., Hoboken, New Jersey, USA, 2010.
- Ahmad K., Rustam G.A., Dent M.M., "*Brand preference in Islamic banking"*, Journal of Islamic Marketing Vol. 2 No. 1, , Emerald Group Publishing Limited, 2011.
- Federal Reserve Bank of San Francisco," *Islamic Finance: Malaysia's Growing Role"*, Asia Focus, Country Analysis Unit, July 2009. www.frbsf.org/publications/banking/asiafocus/2009/asia_focus_july_09.pdf
- Hefner R. W.,"*Islamic Economics and Global Capitalism"*, SOCIETY, (Volume 44, Number 1), November/December, The State University of New Jersey, USA, 2006.

- Kahf M., Khan T., "*Principles of Islamic Financing – A Survey"*, Research Paper No. 16, Islamic Research and Training Institute, Islamic Development Bank, 1992.
- Karim R.A.A.,"*International accounting harmonization, banking regulation, and Islamic banks*" The International Journal of Accounting 36 (2001) Accounting and Auditing Organization for Islamic Financial Institutions, Manama, Bahrain, 2001.
- Khan F., "*How 'Islamic' is Islamic Banking*?", Journal of Economic Behavior & Organization 76 (2010), doi:10.1016/j.jebo.2010.09.015, 2010 Elsevier.
- Mansour W., Ben Abdelhamid M., Masood O., Niazi G.S.K.," *Islamic banking and customers'preferences: the case of the UK*", Qualitative Research in Financial Markets Vol. 2 No. 3, Emerald Group Publishing Limited, 2010. www.emeraldinsight.com/1755-4179. htm
- Muneeza A., Wisham I., Hassan R.," *The Paradox Struggle Between the Islamic and Conventional Banking Systems*", Journal of Asia Pacific Studies Vol 1, No 2, International Islamic University Malaysia, 2010.
- Nienhaus V., "*Governance of Islamic banks, Handbook of Islamic banking"*, Edward Elgar Publishing Limited, U.K. 2007.
- Shaikh S. A., "*A Brief Review & Introduction to Practiced Islamic Banking & Finance*", January 14, 2010. http://ssrn.com/abstract=1536943
- Solé Juan," *Introducing Islamic Banks into Conventional Banking Systems*" Working Paper 07/175, International Monetary Fund, 2007.
- Venardos Angelo M., "*Islamic banking and finance in South-east Asia : Its development and future"*, World Scientific Publishing Co. Pte. Ltd., Singapore,2005.
- Volk S., Pudelko M.,"*Challenges and opportunities for Islamic retail banking in the European context: Lessons to be learnt from a British – German comparison"*, Journal of Financial Services Marketing Vol. 15, 3,, Macmillan Publishers Ltd. 2010.