Introduction to Islamic Banking: A Basic Concept

Dedy Dwi Prastyo
Wolfgang Karl Härdle

Ladislaus von Bortkiewicz Chair of Statistics
C.A.S.E. – Center for Applied Statistics
and Economics
Humboldt–Universität zu Berlin
http://lvb.wiwi.hu-berlin.de
http://www.case.hu-berlin.de

Type of Islamic banking

- Islamic commercial banks
- Islamic investment banks

  Amana investment (HSBC), Noriba (UBS), etc.
- Islamic units of conventional banks

  UBS, Credit Swiss, Standard Chartered, etc.

Focus area development

- In 1970's – Commercial banking
- In 1980's – Project finance and syndications
- In 1990's – Equity, Leasing (Ijarah)
- In 2000's – Bonds (sukuk)

HSBC

Figure 1: Islamic fund distribution area

Outline

1. Motivation ✓
2. Islamic banking
3. Islamic banking products
4. References

What is Islamic banking

- The subject matter of Islamic banking is the economy (activity)
- Banks earns profit from participating in economy, by sharing risks and rewards through pricing of goods, service and benefits $\rightarrow$ Profit and Loss Sharing (PLS)
- Consequently there are no interest based contracts

What is interest based banking

- The subject matter of interest based banking is money
- Banks treat money as commodity and earn profit from pricing the money
- Therefore most transactions are interest based

Example

If A save his money in the bank

- A will get 5% per year of his investment. It is not allowed (interest rate)
- A will get percentage of profit based on his capital percentage. It is allowed (profit sharing)

What is the difference ?

Operationally, Islamic banking looks similar to conventional banking, but they have different principles

Conventional bank	Islamic bank
1. Use money as a comodity	1. Create link to real sector by using trade related activities
2. Is based on interest	2. Is based on profit or rent
3. Deals in money or papers	3. Deals in asset
4. Is based on fixed return on both sides of balanced sheet	4. Is based on profit sharing on deposit side, and on profit on asset side
5. Does not involve itself in trade and business	5. Actively participate in trade, production, and valid service through valid contracts
6. Status – creditors and debitors	6. Status – partners, investor, trader, buyer, and seller

Table 1: Conventional vs. Islamic banking.

Islamic banking products

- Participatory (PLS principle)
  - Mudharabah (investment management), Musharakah (partnership), Diminishing Musharaka, Equity participation
- Trading (Fee or charges based principle)
  - Ijarah (leasing), Buying and Selling (Murabaha, Musawamah, Tawarruq), Salam (forward sale contract), Istisna' (contract of work)
- Free-service principle – Qard hasan
- Ancillary principle – Wadiah, Rahn, Wakalah (agency), Assignment of Debt, Kafalah

Mudharabah (investment management)

Contract that include financier and the agent (mudarib) who invest the financier's capital on his behalf

- Conduct of business within a framework
- Sharing of profit in agreed proportion
- Financial loss on capital only
- Liability of investor limited to his investment
- Can not be traded in financial market

Musharakah (partnership)

Two or more parties combine their capital to share the generated profit

- Proportions for profit sharing are predetermined before entering the contract
- Losses are borne proportionally to the portion in partnership
- Musharakah loan are marketable in financial market
- Certificates (or securities) must represent the real asset, i.e. house, factory, etc.

Introduction to Islamic Banking: A Basic Concept

Dedy Dwi Prastyo
Wolfgang Karl Härdle

Ladislaus von Bortkiewicz Chair of Statistics
C.A.S.E. – Center for Applied Statistics and Economics
Humboldt–Universität zu Berlin
http://lvb.wiwi.hu-berlin.de
http://www.case.hu-berlin.de

References

Hasan, M.K. and Lewis, M.K.
Handbook of Islamic Banking
Springer Verlag, New York, 1995

What is usury (riba) ?

- Riba is any unjustifiable increase of capital whether in loans or sales, e.g. collection and payment of interest
- Trade is permitted and riba is prohibited
- Riba is categorized into two:
  - Riba-un-Nasiyah (Riba-al-Jahiliya)
  - Riba-al-Fadl (Riba-al-Bai)

What is usury (riba) ?

- Riba-un-Nasiyah (Riba-al-Jahiliya)
  - Kind of loan where specified repayment period and an amount in excess of capital is predetermined
  - All loan that draw interest is riba
- Riba-al-Fadl (Riba-al-Bai)
  - Gold in exchange of equivalent gold, wheat in exchange of equivalent wheat, etc.
  - If a person transacts in excess, it is usury (riba)

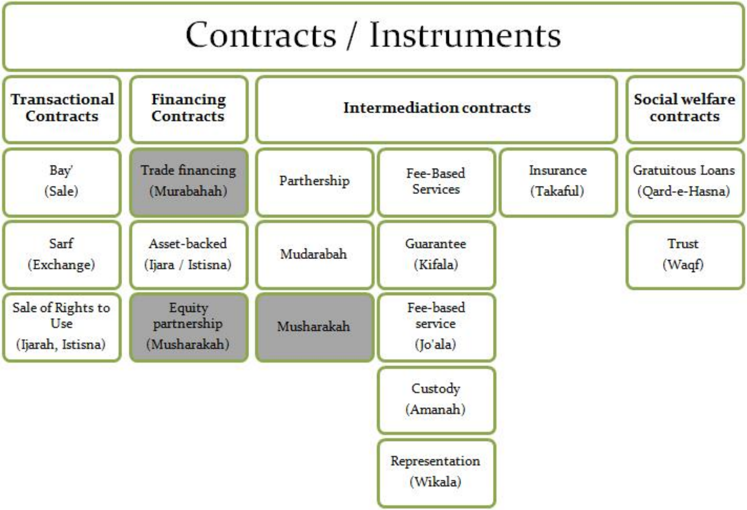

Figure 2: Instruments in Islamic finance